Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

17th November 2017

Market Overview

No.	Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
1	FTSE 100	7386.94	▼-1.3	▼-1.86	▲9.44	7562.28	6730.72	6/11/17	2/12/16
2	FTSE 250	19850	▼-1.11	▼-1.82	▲13.6	20472.4	17435.3	3/11/17	2/12/16
3	FTSE SmallCap	5754.86	▼-1.28	▼-1.63	▲17.7	5892.71	4884.38	3/11/17	21/11/16
4	FTSE AIM 100	5220.68	▼-1.37	▼-0.46	▲34.8	5377.07	3869.3	7/11/17	6/12/16
5	FTSE All-Share	4056.4	▼-1.27	▼-1.84	▲10.4	4156.95	3665	3/11/17	2/12/16
6	S&P 500	2583.08	▼-0.0596	▲0.995	▲18.7	2594.38	2176.94	8/11/17	16/11/16
7	Brent Oil Spot $	$61.5995	▼-3.51	▲6.36	▲32.9	$64.08	$44.785	6/11/17	21/6/17
8	Gold Spot $ per oz	$1279.75	▼-0.497	▼-1.19	▲4.31	$1349.10	$1128.22	7/9/17	15/12/16
9	GBP/USD - US Dollar per British Pound	1.31955	▲0.402	▼-0.437	▲6.08	1.3591	1.20401	15/9/17	16/1/17
10	GBP/EUR - Euros per British Pound	1.1206	▼-0.7	▼-0.276	▼-3.55	1.1972	1.0795	18/4/17	29/8/17

Top Risers

No.	TIDM	Name	%chg 1w
1	GOCO	Gocompare.com Group PLC	▲13.7
2	CMS	Communisis PLC	▲11.3
3	FENR	Fenner PLC	▲8.04
4	PFD	Premier Foods PLC	▲7.84
5	MCS	McCarthy & Stone PLC	▲7.71
6	MOTR	Motorpoint Group PLC	▲7.59
7	HFD	Halfords Group PLC	▲7.5
8	RNO	Renold PLC	▲7.42
9	CCC	Computacenter PLC	▲7.34
10	ICP	Intermediate Capital Group PLC	▲7.26

Top Fallers

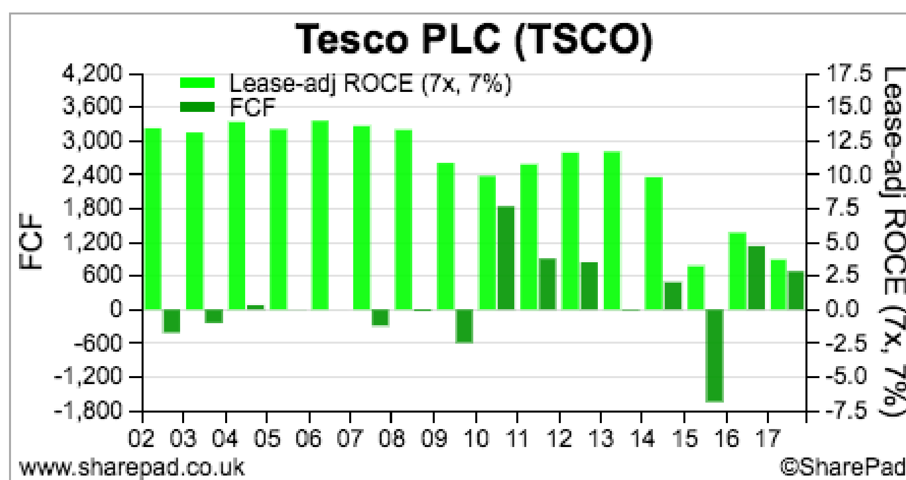
No.	TIDM	Name	%chg 1w
1	ULE	Ultra Electronics Holdings PLC	▼-30.7
2	HSS	HSS Hire Group PLC	▼-26.8
3	DTY	Dignity PLC	▼-19.8
4	TALK	TalkTalk Telecom Group PLC	▼-16.7
5	QQ.	QinetiQ Group PLC	▼-13.7
6	TLW	Tullow Oil PLC	▼-13.1
7	MTC	Mothercare PLC	▼-12.6
8	UPGS	UP Global Sourcing Holdings ...	▼-12.4
9	DPEU	DP Eurasia NV	▼-12.2
10	SDL	SDL PLC	▼-10.6

Tesco (LSE:TSCO)

I've been a bear of Tesco and supermarket shares in general for many years. Even when Tesco was supposedly firing on all cylinders a decade or so ago I was never tempted to invest in its shares.

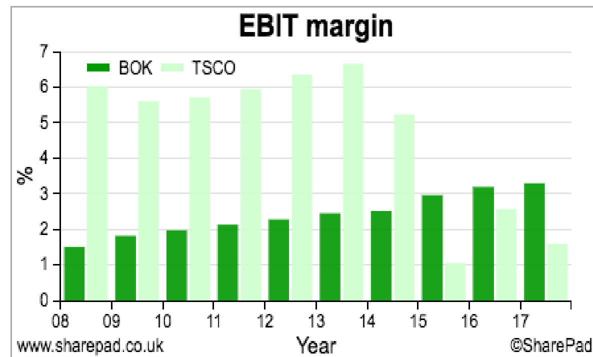
For years Tesco grew its profits by opening lots of new supermarkets across the world and benefitted from the maturation effect - the steady growth of sales over a couple of years from opening to their natural level. This boosted its like-for-like sales - the most closely watched measure of a retailer's trading performance - and was mistaken for genuine underlying growth when it wasn't really.

Tesco became so big that it struggled to make gains from opening new stores without taking sales from the ones it already owned - known in the trade as sales cannibalisation. At the same time, returns on capital employed (ROCE) were falling and free cash flow performance was weak.



Problems overseas compounded these issues and saw a collapse in profitability.

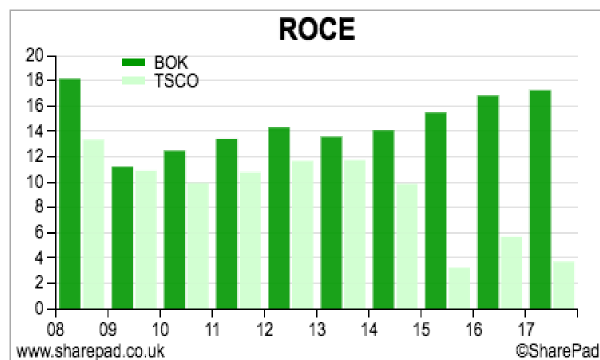
Tesco has been spending the last few years trying to get back on track. I've walked around a few stores near where I live and can definitely see improvements. Price competitiveness has improved as product ranges have been cut down to give better buying power and things like till availability have been good.



Yet Tesco has continued to struggle. It has continued to lose market share to discounters Aldi and Lidl who now look like the price setters in the UK. Progress towards the 4% profit margin target has been painfully slow.

To me this is one of the main reasons why Tesco is buying food wholesaler Booker (LSE:BOK) which the competition authorities (CMA) approved this week.

During the last couple of years Booker's profit margins have been comfortably higher than Tesco's as has its ROCE.



Adding in Booker's £200m of trading profits at a margin of just over 3.6% will increase Tesco's profits by just over 12% and give a boost to its own profit margins and ROCE.

Tesco is buying a nice business in Booker but is paying nearly 24 times forecast earnings to get its hands on it which is why some Tesco shareholders are a bit upset about the deal. However, this ignores the £200m of cost savings Tesco expects to get out of combining Booker with its own business. This makes the deal easier to swallow, especially as cost-saving estimates tend to be conservative when deals are announced.

But does this deal really transform the growth prospects, profitability and ROCE of Tesco in the UK? Rival retailers and wholesalers are up in arms about it and make some arguments about competition that are difficult to dispute.

Despite playing down their significance, Tesco will get control of Booker's network of Premier, Londis and Budgens convenience stores. These stores will surely benefit from Tesco's immense buying power and become more competitive as a result.

Yet you still cannot get away from the fact that selling food in the UK is a fiercely competitive, low margin business that struggles to create much long term prosperity for investors. I don't think anything is going to change in this respect.

However, the CMA's decision to wave through Tesco's purchase of Booker could lead to more deals in the sector. Could convenience store operator McColl's (LSE:MCLS) now become a target for Sainsbury's (LSE:SBRY)? Might Morrisons (LSE:MRW) buy a company such as Iceland? The grounds for blocking such deals now look very weak in light of this week's events.

The main reason why supermarket shares have been poor investments is that there are too many supermarkets chasing too few shoppers. This has been kinder to shoppers than shareholders. Some consolidation in the sector may change this balance.

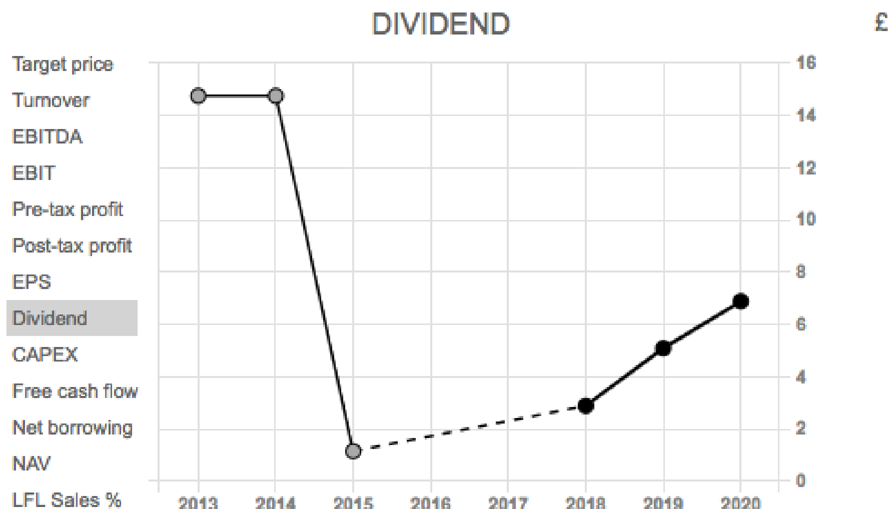
As far as Tesco is concerned, this deal is a positive development. Its shares are not particularly cheap even with this deal and its ongoing cost cutting. But they are a lot cheaper than a year ago. The one year forecast rolling PE is 15.5 times before the Booker purchase has been factored in.

In my article for the Investors Chronicle last week, I cited Tesco as a share that might be of interest for income seekers given the expectation of a growing dividend. Beyond that, I see few fundamental attractions to buy the shares.

Tesco PLC (TSCO)

FORECASTS — £ millions unless stated

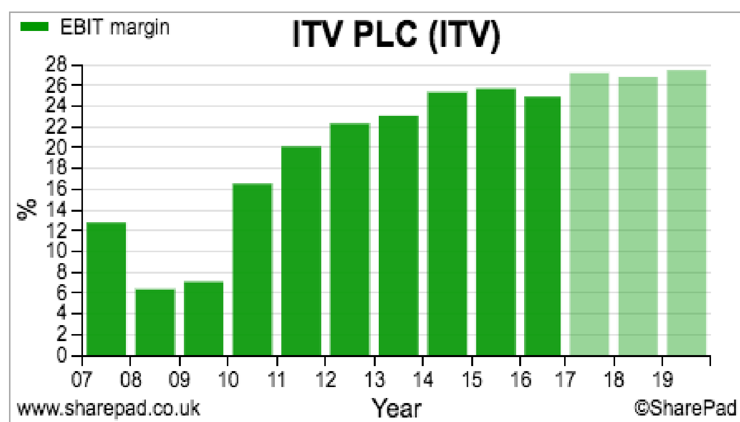
Year	2018		2019		2020	
Turnover	57,297.5	+2.5%	59,007.5	+3.0%	60,032.5	+1.7%
EBITDA	2,881.7	+31.9%	3,142.9	+9.1%	3,441.6	+9.5%
EBIT	1,572.8	+77.3%	1,804.2	+14.7%	2,093.5	+16.0%
Pre-tax profit	1,172.0	+4783.2%	1,481.5	+26.4%	1,779.5	+20.1%
Post-tax profit	851.0		1,116.0	+31.1%	1,399.7	+25.4%
EPS (p)	10.3		12.8	+24.3%	15.7	+22.7%
Dividend (p)	2.9		5.1	+75.9%	6.9	+35.3%
CAPEX	1,156.1	-15.9%	1,288.2	+11.4%	1,326.6	+3.0%
Free cash flow	826.6	+20.8%	1,058.0	+28.0%	1,223.3	+15.6%
Net borrowing	3,130.3	-65.0%	3,397.8	+8.5%	1,960.6	-42.3%
NAV	10,938.0	+69.9%	11,819.0	+8.1%	12,842.0	+8.7%
Like for like sales growth %	2.0		-		-	



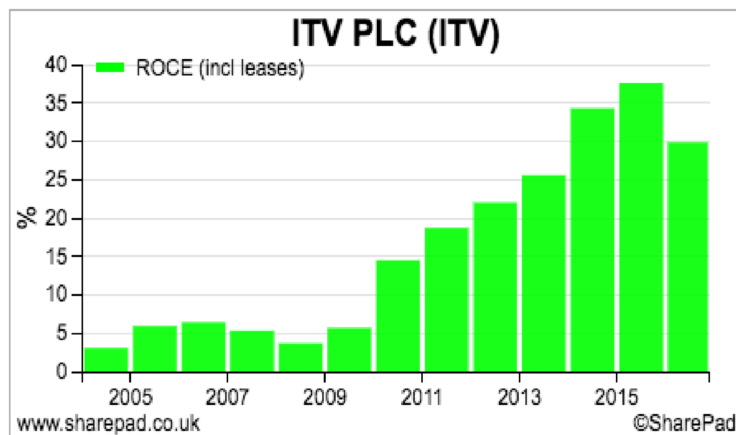
ITV (LSE:ITV)

At first glance, ITV is the kind of business that I would normally want to own a slice of.

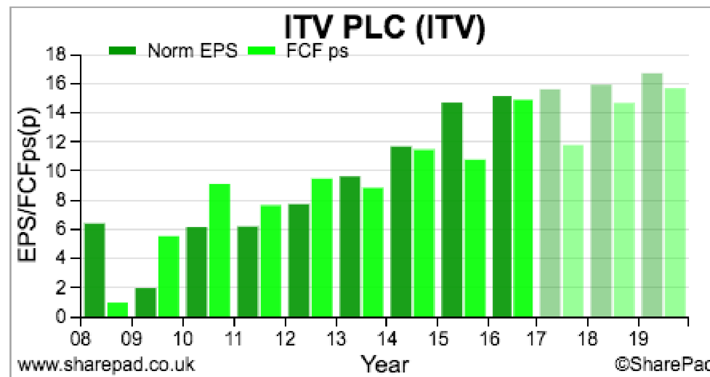
It has high profit margins...



and high returns on capital employed.



It is also very good at turning most of its profits into free cash flow.



On top of all this its shares can currently be bought for just 9.5 times forecast EPS. What's not to like?

Yet ITV's share price has been drifting lower for the best part of two years despite many analysts holding positive views.

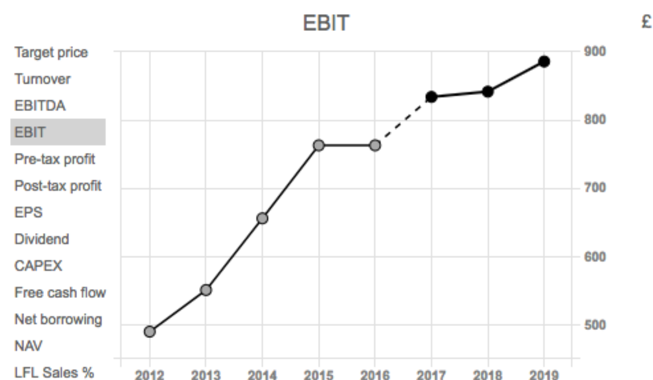
ITV PLC (ITV)

BREAKDOWN

	Opinion		Brokers	
	1	Buy	7	
	2	Out perform	6	
	3	Hold	8	
	4	Under perform	1	
	5	Sell	1	
	0	No opinion	0	Not included in consensus
	2.26	**Out perform**	**23**	**Consensus**

FORECASTS £ millions unless stated

Year	2017		2018		2019	
Turnover	3,069.0	+0.2%	3,139.7	+2.3%	3,225.9	+2.7%
EBITDA	887.1	+0.5%	890.2	+0.3%	934.7	+5.0%
EBIT	834.0	+9.3%	841.7	+0.9%	885.9	+5.3%
Pre-tax profit	789.0	+10.0%	817.0	+3.6%	880.3	+7.7%
Post-tax profit	625.1	+2.1%	626.6	+0.2%	656.5	+4.8%
EPS (p)	15.6	+3.0%	15.9	+1.9%	16.7	+5.0%
Dividend (p)	8.6	+19.4%	9.2	+7.0%	10.1	+9.8%
CAPEX	81.1	+84.4%	54.8	-32.4%	53.7	-1.9%
Free cash flow	474.6	-20.8%	591.2	+24.6%	631.7	+6.8%
Net borrowing	823.4	+28.9%	728.3	-11.5%	668.1	-8.3%
NAV	-		-		-	
Like for like sales growth %	-		-		-	



During this time, the bull case for the shares has been based on the following fundamental points:

- A scarce free-to-air TV asset which can deliver the mass audiences (5 million or more) that advertisers want.
- A growing and profitable TV content business in the form of ITV Studios.
- Less dependence on advertising with non-advertising revenue over half of total revenue.
- Great cash flows which support growing and special dividend payments.
- A takeover target for a company such as Liberty Media.

Yet sentiment towards the shares is currently very poor because big companies are spending less on advertising. ITV's total net advertising revenue is down by 7% during the first nine months of 2017.

Despite the company's efforts to diversify away from advertising there are still grounds for arguing that it is too dependent on it.

ITV Broadcasting & Online (£m)	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**TTM**
Net advertising revenue (NAR)	1,425	1,291	1,496	1,510	1,510	1,542	1,629	1,719	1,672	1,603
Other revenue	258	252	275	310	324	354	394	427	460	468
Total revenue	**1,683**	**1,543**	**1,771**	**1,820**	**1,834**	**1,896**	**2,023**	**2,146**	**2,132**	**2,071**
Schedule costs	-1,125	-1,006	-1,023	-1,004	-996	-983	-1,018	-1,045	-1,050	-1,035
Other costs	-438	-426	-421	-425	-425	-426	-437	-442	-440	-418
EBIT	**120**	**111**	**327**	**391**	**413**	**487**	**568**	**659**	**642**	**618**
EBIT margin	**7.1%**	**7.2%**	**18.5%**	**21.5%**	**22.5%**	**25.7%**	**28.1%**	**30.7%**	**30.1%**	**29.8%**

Non-advertising revenues may now account for half total revenues but **profits** from the core Broadcasting business make up nearly three quarters of ITV's total operating profits (EBIT). In this business, advertising revenue currently makes up 77% of total revenue. This is why investors and analysts start worrying when advertising revenue starts to fall.

The table above shows the makeup of the Broadcasting business' revenues and costs for the last decade. If we go back to the 2008/09 recession we can see a sharp fall in NAR of nearly 10%. The company limited the damage to profits by slashing scheduling (programming) costs.

Since then, the operating costs of this business have barely changed at around £1.45bn per year. The growth in profits has come from the recovery in NAR and growth of digital revenues. Most of the growth in revenues has dropped through to profits. This has resulted in operating margins increasing from just over 7% to 30% - a tremendous result.

This begs the question of how much surplus costs remain to be cut. There are clearly still some as the annual run rate on costs is down by £37m so far this year but I do wonder how long ITV can keep cutting costs. Over the last 18 months, revenues have fallen by £75m (3.5%) and trading profits have fallen by £41m (6.2%).

My concern is that ITV cannot slash programming costs too much without sacrificing quality which feeds through to audience numbers which in turn drives advertising revenues.

ITV's large fixed cost base makes its Broadcasting profits very sensitive to changes in revenue and advertising revenue in particular, particularly as non-advertising revenue growth looks as if it is slowing down. It is this operational gearing which represents the big risk to shareholders in my view.

The big unknown for me and others regarding ITV is whether its advertising-funded broadcast model can survive in a changing world of viewing habits. Netflix, Amazon Prime and Now TV all allow viewers to watch programmes when they want to without seeing adverts for a modest outlay of around £8 per month.

This explains why ITV has launched ITV Hub+ which offers the same ad-free experience for £4 per month. Given its lack of programming depth in relation to the major players in this market it will be interesting to see how many people subscribe to this service on a long-term basis.

I am certain that there is substantial value within the business given its content within ITV Studios and extensive archive. The issue is how this will be unlocked in the absence of a takeover bid.

At 150p per share, its current enterprise value (including pension fund deficit) is around £7bn. A takeover premium on the shares of 30% would push up the price to around £8.8bn for a business with forecast trading profits of £834m for 2018. That would give a buyer a pre-tax return on investment of 9.5%.

A 10% fall in advertising revenues (c£160m) falling straight through to profits would reduce that return to 7.7% which isn't that great. This may explain why a bid has not yet materialised for ITV.

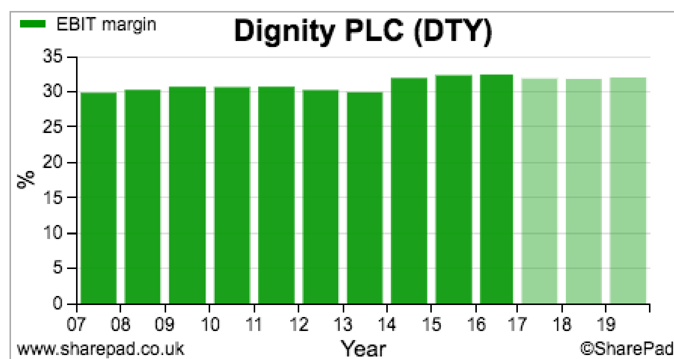
A move towards a more subscription-based business has been suggested by some commentators in the past. This could make sense but would take a long time to build up in my opinion.

I can see why income seekers (the forecast yield is 5.7%) and value investors might be interested in ITV shares and they may well be rewarded one day. In the short run, concerns about advertising revenues and its current business model may continue to weigh on the share price.

Dignity (LSE:DTY)

(Disclosure: I currently own shares in Dignity.)

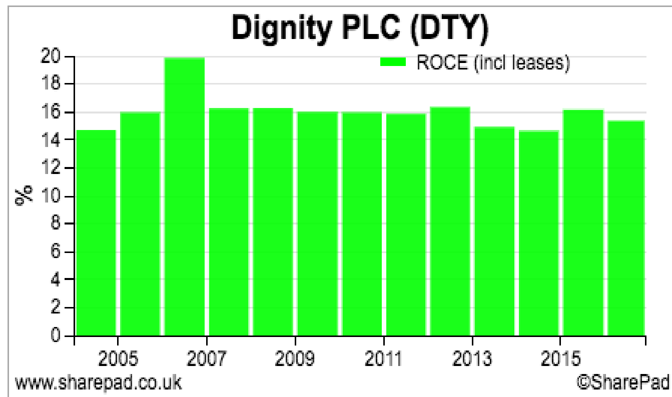
It's fairly safe to say that Dignity is one of the most predictable businesses listed on the stock exchange. The sad fact that all of us will die one day means that the business of funerals is unlikely to disappear or be replaced by something else.



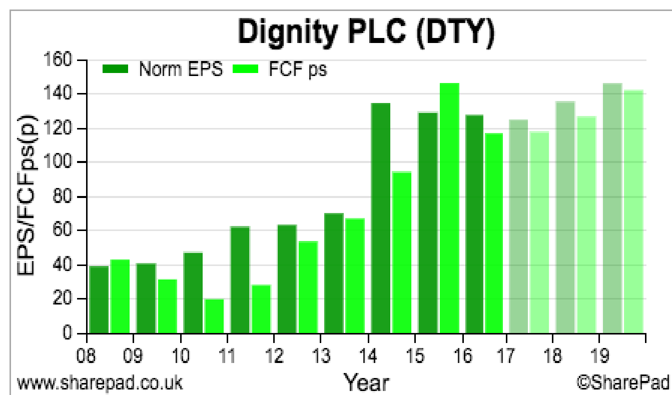
Whilst the number of deaths in the UK does move around from year to year there are rarely wild swings, The predictability of funerals has seen Dignity become a highly sought after share and one which has produced very good long-term returns for shareholders.

As we can see, it is a very profitable business with high and stable profit margins. This is a business which has historically had a high degree of pricing power and has been able to keep on raising its prices for funerals and cremations to offset rising costs

Even when the assets of funeral shops and crematoria are taken into account, the business has delivered very acceptable returns on capital and has also been a good generator of free cash flow.



However, despite buying up rival funeral businesses on a regular basis, earnings growth has been hard to come by in recent years. Whilst it has been able to do well in selling pre-paid funerals and cremations its day-to-day funeral business has faced increasing amounts of competition.



This week's third quarter trading statement contained the following comment which spooked investors and led to a sharp sell-off. This was despite full year profit expectations being maintained.

"Whilst our pre-arranged and crematorium businesses are performing strongly, we continue to see increasing price competition and new competitors in our funeral business."

However, Dignity has been losing market share (just under 12%) in recent years and there are bound to be fears that this trend might continue.

A basic law of economics is that high levels of profits will attract competitors who will drive down profit margins and returns on capital employed. This can be prevented if there are high barriers to new entrants.

Barriers to entry do exist in crematoria as they cost money to build, require planning permission and are subject to regulations but anyone can set up in business as a funeral director. And with big fat profit margins on offer you can see why some people might.

Funerals are eye-wateringly expensive. In most cases you'll be lucky to get any change from £3,000 before paying another £1,000 for a cremation on top. It is understandable why people would look to get this cost down.

As a shareholder, the threat to Dignity's profit margins is something you need to think about. Are current competitive threats the beginning of a steady decline in its margins?

It has to be a possibility which is why Dignity continues to campaign for the regulation of funeral companies in order to deter new entrants. Yet the company does have some defences.

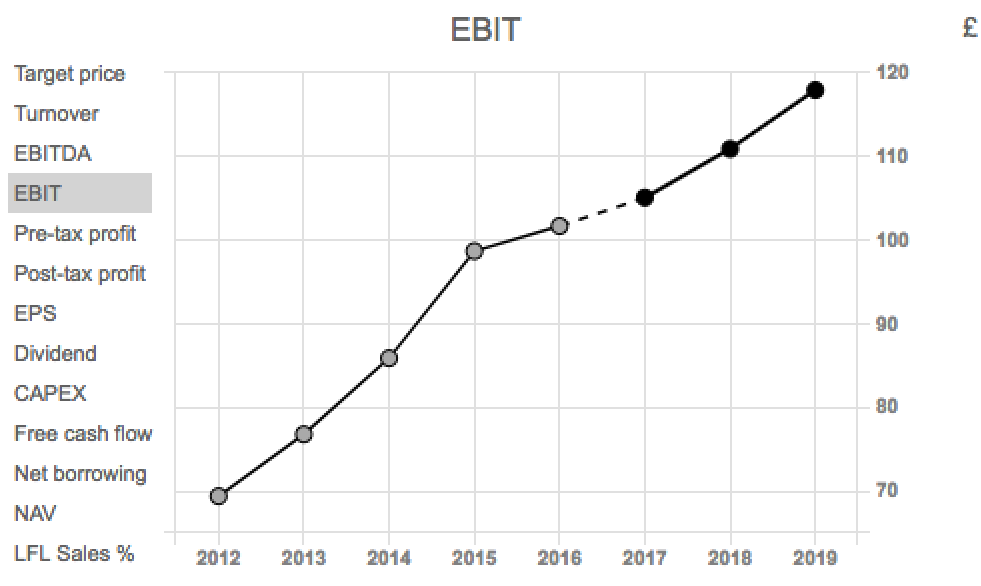
Firstly, funerals are a local business where reputation and quality of service are paramount. Dignity trades under local names - usually a family business - that have often been established for years. Dignity is looking to enhance its businesses by investing in its online business as more business moves to the internet.

It can therefore be very difficult and time-consuming for new entrants to take market share but it cannot be denied that Dignity is under some pressure. I think it's fair to assume that the days of Dignity jacking up its prices every year may have come to an end. Consumers' wallets even with a traumatic event can only take so much.

Dignity PLC (DTY)

FORECASTS — £ millions unless stated

Year	2017		2018		2019	
Turnover	329.8	+5.2%	348.7	+5.7%	368.4	+5.7%
EBITDA	122.6	+4.0%	129.3	+5.5%	137.2	+6.2%
EBIT	105.1	+3.3%	110.9	+5.5%	118.0	+6.3%
Pre-tax profit	78.5	+3.5%	84.9	+8.1%	91.9	+8.2%
Post-tax profit	62.5	-1.7%	67.8	+8.4%	73.3	+8.2%
EPS (p)	124.7	-2.1%	135.3	+8.5%	146.1	+8.0%
Dividend (p)	26.0	+10.2%	28.5	+9.6%	31.2	+9.5%
CAPEX	24.0	+5.3%	21.0	-12.5%	21.0	0.0%
Free cash flow	58.7	+0.7%	63.1	+7.6%	70.8	+12.2%
Net borrowing	498.1	-4.8%	463.0	-7.0%	408.9	-11.7%
NAV	-		-		-	
Like for like sales growth %	-		-		-	



Secondly, Dignity has proven to be very effective at buying up rival funeral businesses in what remains a very fragmented market. Its size gives it the firepower to do this without triggering competition concerns

There are legitimate reasons for avoiding shares in Dignity. High debts are not one of them in my view. Fixed charge cover is currently three times which is fine given the strong and predictable cash generation of the business.

What makes the shares more interesting is that the valuation of them has come down sharply. A couple of years ago you would have had to pay 22 times forecast EPS. Today they are on sale for a one year forecast rolling PE of just over 16. For a business that is more predictable than most, this looks more reasonable value.

I am hanging on to my shares, but time will tell whether I am right to do so as I will concede that there is a risk that they might have become a value trap.

Housebuilders

It has been another good year for most housebuilder shares although the last month has been a bit rocky. Recent trading statements have generally said that everything is fine. The exception has been Persimmon which caused a few jitters when it said that it was selling the same number of houses per site as last year but was selling from 10% fewer sites.

Name	Close	%chg 2/1/17	%chg 1m	fc PE	fc Yield	Price to NTAV	fc ROCE	fc ROE	fc Net borrowing
Barratt Developments PLC	622p	▲34.5	▼-8.66	9.6	7.0	1.8	21.8	16.5	-639.8
Bellway PLC	£34.75	▲40.3	▼-1.28	8.3	3.9	1.9	31.2	24.0	-43.6
Berkeley Group Holdings (The) PLC	£36.50	▲30	▼-5.46	7.7	5.2	2.4	27.1	29.3	-394.0
Bovis Homes Group PLC	£11.08	▲35.1	▼-7.36	15.1	4.3	1.5	12.3	9.5	-49.7
Countryside Properties PLC	334p	▲34.2	▼-8.04	12.4	2.4	2.8	26.8	19.9	-63.5
Crest Nicholson Holdings Ltd	496.2p	▲9.54	▼-13.4	7.5	6.9	1.8	21.5	22.4	-50.0
Galliford Try PLC	£11.43	▼-11.5	▼-14.6	6.8	8.6	2.4	8.3	16.1	243.4
McCarthy & Stone PLC	156.6p	▼-2.73	▲3.09	9.2	3.5	1.2	15.4	12.5	-33.9
MJ Gleeson PLC	710p	▲30.3	▲0.996	13.4	3.6	2.2		16.9	-34.5
Persimmon PLC	£26.69	▲50.3	▼-4.92	10.8	5.1	3.3	34.1	27.2	-1121.4
Redrow PLC	584.5p	▲36.2	▼-7.37	7.5	3.7	1.8	23.1	21.1	51.4
Taylor Wimpey PLC	192p	▲25.1	▼-5.14	9.9	7.1	2.2	26.2	20.5	-430.9
Telford Homes PLC	406p	▲28.6	▲1.56	8.7	4.2	1.5	10.8	16.3	183.2

The builders have arguably never had it so good. Their profits, margins, returns on equity are at or close to record highs. Balance sheets are in rude health with many forecast to have substantial net cash balances.

Valuations as measured by the ratio of share prices to net tangible assets per share (Price to NTAV) are also close to record highs. It's not too unreasonable for people to ask if this is as good as it gets?

But the current housing market is unlike any that has come before it. This is because the housebuilders are receiving unprecedented levels of taxpayer-funded support in

the form of the Help to Buy scheme. This gives buyers 20% interest free loans on new build properties up to a value of £600,000 for five years. The loan increases to 40% in London. One in two new houses sold by Persimmon uses the scheme. For other builders this is around 30%-40%.

Help to Buy achieves three things:

1. It puts money in buyers' pockets. This despite the fact that there are plenty of 95% loan to value (LTV) mortgages currently on the market.
2. It takes a lot of risk away from lenders. 95% LTV mortgages effectively become 75% with the government chipping in 20%.
3. Builders can increase selling prices more easily. The 75% LTV means that lenders are unlikely to value them down for mortgage purposes.

This scheme was supposed to stimulate the building of new homes but what it has largely achieved is a massive increase in housebuilders' profits. I've put together a table of the big four national builders and looked at the changes in their completions and pre-tax profits between 2013 (when the Help to Buy scheme started) and their last reported annual profits.

	2013		Latest Annual		
Builder	**Completions**	**Pretax (£m)**	**Completions**	**Pretax (£m)**	**Pretax (F)**
Persimmon	11,528	330	15,171	782.8	963.3
Barratt	13,663	192.6	17,395	765.1	815.9
Taylor Wimpey	11,696	314.5	13,808	733.4	808.3
Bellway	5,652	140.9	9,644	560.7	636.9
Total	**42,539**	**978**	**56,018**	**2842**	**3224.4**
Change vs. 2013			**32%**	**191%**	**230%**

What we can see is that the scheme helped the builders to sell 32% more houses but that their profits increased nearly threefold with another hefty increase forecast.

Some of this is due to luck and the clever use of land bought in the recession or the use of strategic land (land bought without planning permission which was subsequently granted). However, there can be no doubt that Help to Buy has been

the major driver of profitability. This has been achieved by pushing up house prices which leverages up the profits on the cost of the builders' land banks.

Investors in housebuilder shares may see little cause for concern. After all, the government has pledged a further £10bn for Help to Buy. The Labour party manifesto promised to extend the scheme until 2027.

Does this mean that housebuilders and their shareholders will continue to make hay?

Maybe.

However, there is a chance that this scheme could run out of steam. This might not come from a house price crash as some people predict. It might occur because the price differential between new build and existing houses is widening which makes new houses look overpriced and increasingly poor value for money.

Help to Buy was removed from the second hand housing market at the end of 2016 due to the increase in the number of 95% mortgages available. This meant that the government felt that it did not need to subsidise mortgages. The scheme for new builds runs until 2021 as the government wants to increase the supply of houses and probably due to some effective lobbying from the builders themselves.

It may be a coincidence but the second hand housing market has cooled significantly over the last year whilst the new build market has continued in rude health.

New houses have always commanded a price premium but according to a widely cited report by investment bank Morgan Stanley a few weeks ago the premium has rocketed since Help to Buy began and is now at record levels. This adds weight to the view - and one that I agree with - that Help to Buy has mainly helped people to buy expensive new houses and allowed builders to make massive profits.

I think that the political risk to the building industry is increasing. The government is under tremendous pressure to increase the supply of new homes and especially affordable ones. A growing price premium for new builds with this backdrop raises the risk that the nature of the scheme may change or that a new one will significantly increase supply and lower selling prices.

Next week's budget (22nd November) should be closely watched by builders and their shareholders.