Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

24th 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	7404.23	▲0.319	▼-1.63	▲8.42	7562.28	6730.72	6/11/17	2/12/16
2	FTSE 250	19976.2	▲0.901	▼-0.681	▲13.6	20472.4	17435.3	3/11/17	2/12/16
3	FTSE SmallCap	5787.47	▲0.645	▼-0.41	▲17.6	5892.71	4907.17	3/11/17	2/12/16
4	FTSE AIM 100	5300.43	▲1.22	▲2.16	▲34.8	5377.07	3869.3	7/11/17	6/12/16
5	FTSE All-Share	4069.07	▲0.427	▼-1.43	▲9.57	4156.95	3665	3/11/17	2/12/16
6	S&P 500	2597.08	▲0.707	▲1.09	▲17.8	2599.03	2191.08	21/11/17	1/12/16
7	Brent Oil Spot $	$63.426	▲1.1	▲8.34	▲29.7	$64.08	$44.785	6/11/17	21/6/17
8	Gold Spot $ per oz	$1291.45	▼-0.199	▲1.23	▲8.87	$1349.10	$1128.22	7/9/17	15/12/16
9	GBP/USD - US Dollar per British Pound	1.33302	▲0.881	▲1.52	▲7.05	1.3591	1.20401	15/9/17	16/1/17
10	GBP/EUR - Euros per British Pound	1.1226	▲0.17	▲0.546	▼-4.8	1.1972	1.0795	18/4/17	29/8/17

Top Risers

No.	TIDM	Name	%chg 1w
1	SERV	Servelec Group PLC	▲23.2
2	OPHR	Ophir Energy PLC	▲15.4
3	NANO	Nanoco Group PLC	▲13.3
4	DPLM	Diploma PLC	▲11.7
5	EIG	EI Group PLC	▲10.9
6	ACA	Acacia Mining PLC	▲10.2
7	BYG	Big Yellow Group PLC	▲9.8
8	HTG	Hunting PLC	▲8.94
9	ETO	Entertainment One Ltd	▲8.91
10	FENR	Fenner PLC	▲8.71

Top Fallers

No.	TIDM	Name	%chg 1w
1	SPO	Sportech PLC	▼-24.6
2	CLLN	Carillion PLC	▼-18.6
3	MTC	Mothercare PLC	▼-16.9
4	XAR	Xaar PLC	▼-16.6
5	CNA	Centrica PLC	▼-15.9
6	SPI	Spire Healthcare Group PLC	▼-13
7	IRV	Interserve PLC	▼-11.3
8	BAB	Babcock International Group P...	▼-10.9
9	TALK	TalkTalk Telecom Group PLC	▼-10.4
10	DIA	Dialight PLC	▼-9.21

Diploma (LSE:DPLM, Market Cap: £1.35bn)

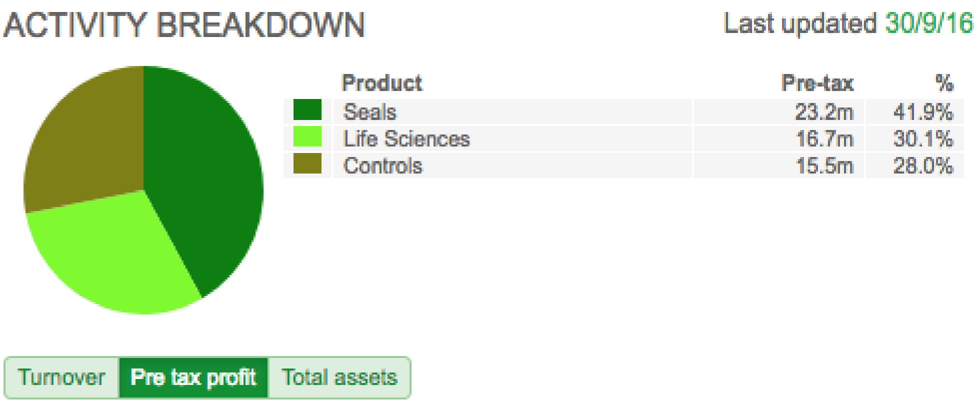
Disclosure: I currently own shares in Diploma.

I last looked at Diploma back in May at the time of its interim results. I said back then that it was the kind of business that I liked and I bought some shares last month for my SIPP.

In brief, this is what the company does and how it is structured.

- **Life Sciences –** It sells medical devices to the Healthcare sector and environmental analysers, and emissions control products to environmental businesses.
- **Seals** - Specialised seals used in mobile machinery and industrial equipment.
- **Controls** - Specialised wiring, connectors, fasteners and control devices. These are used in technically-demanding applications in sectors such as Aerospace, Defence, Energy, Motorsport and Food & Beverages.

Three quarters of Diploma's sales come from outside the UK which means that its sales and profits have received a significant boost from the fall in the value of the pound since June last year. Its profit make up is shown below.



Product	Pre-tax	%
Seals	23.2m	41.9%
Life Sciences	16.7m	30.1%
Controls	15.5m	28.0%

As I showed back in May, this company has some very attractive financial characteristics such as:

- High returns on capital employed (ROCE)
- High profit margins.
- High rates of free cash flow conversion - turning profits into free cash flow.

Strong full year results announced this week saw the continuation of these desirable features and were backed up by decent rates of profit growth.

Regular readers will know that I go on about these key numbers a lot but I want to make it clear that I am not a quantitative ('quant") investor who invests just on the basis of numbers alone. I spend most of my time trying to understand the business behind the numbers and why it can produce a good or bad financial performance. This is time consuming, often not easy and ongoing. I am always learning new things.

When it comes to Diploma, I like the fact that it seems to be operating in profitable niches which come about from selling products and services that solve problems for customers and which don't have lots of strong competitors. I also like the fact that most of its products are day-to-day operating items for its customers which tend to give rise to a much a more regular and dependable source of income than supplying capital equipment which has more chances of being postponed or cancelled.

All of its businesses seem to be performing well, even when the benefits of the weaker pound are taken into account.

One of the simplest but revealing tools of analysis you can perform when a company reports its full year results is to calculate what has gone on during the second half (H2) of the trading year. This is easily done by subtracting the first half results from the full year results in a spreadsheet as shown below. The H2 figures can give you a little bit more of a feel for the current momentum of sales and profits in a business.

Life Sciences	**H1 16**	**H2 16**	**FY 2016**	**H1 17**	**H2 17**	**FY 2017**
Turnover (£m)	52.5	57.4	109.9	57.9	68	125.9
Change				10.3%	18.5%	14.6%
Operating profit (£m)	9.3	10.3	19.6	10.3	13	23.3
Change				10.8%	26.2%	18.9%
Margin	**17.7%**	**17.9%**	**17.8%**	**17.8%**	**19.1%**	**18.5%**

Life Sciences has sizeable businesses in Canada and Australia where there has been quite a bit of price pressure on healthcare budgets. Given that backdrop, underlying sales of growth of 4% and 6% respectively is reasonable. The UK and Irish business was weaker and posted no growth but is not as significant in its total contribution to this division's profits.

Diploma has offset government healthcare budget pressures by winning new business in Canada. In Australia, the recent acquisition of Abacus has increased exposure to private laboratory customers in selling diagnostic instruments.

The Environmental business saw 3% underlying growth despite coming up against strong sales comparatives from last year. Service sales are up and emissions monitoring sales are currently buoyant.

This business looks like it has reasonable momentum with an acceleration of growth during the second half of the year and a decent improvement in operating margins. It looks to be starting the 2017/18 year in good shape.

Seals	**H1 16**	**H2 16**	**FY 2016**	**H1 17**	**H2 17**	**FY 2017**
Turnover (£m)	79.2	87.4	166.6	94.8	100.5	195.3
Change				19.7%	15%	17.2%
Operating profit (£m)	13.4	14.8	28.2	15.4	16.5	31.9
Change				14.9%	11.5%	13.1%
Margin	**16.9%**	**16.9%**	**16.9%**	**16.2%**	**16.4%**	**16.3%**

The Seals business has benefitted from a strong North American market for mobile machinery and industrial equipment but underlying trading elsewhere has been quite weak. There is cause for a little bit of concern on operating margins.

Whilst margins are a little bit better than the second half of the year, the company is commenting about higher supply costs and freight costs. It also mentions discounts and stock control issues eating into margins which makes me think that price competition has increased in this business.

Controls	H1 16	H2 16	FY 2016	H1 17	H2 17	FY 2017
Turnover (£m)	47.4	58.7	106.1	64.6	66.1	130.7
Change				36.3%	12.6%	23.2%
Operating profit (£m)	8.1	9.8	17.9	11.7	11.3	23
Change				44.4%	15.3%	28.5%
Margin	**17.1%**	**16.7%**	**16.9%**	**18.1%**	**17.1%**	**17.6%**

Controls was the star performer. The division saw underlying growth of 14% - excluding currency and acquisitions - and an improvement in profit margins. Specialist cable harnessing - used in Aerospace, Defence and Motorsport - is performing well as are speciality fasteners and fluid controls.

The company was reasonably upbeat about the future prospects of the whole company which suggests that investors can expect further profits growth in 2018. It also signalled its intention to keep on making acquisitions. If it can buy complementary businesses with similar characteristics to what it has already and do this whilst maintaining its high ROCE then this looks like a good thing to do.

That said, I can’t help thinking that the share price has got a little ahead of itself given its reaction to the results.

Diploma PLC (DPLM)

BREAKDOWN

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

FORECASTS

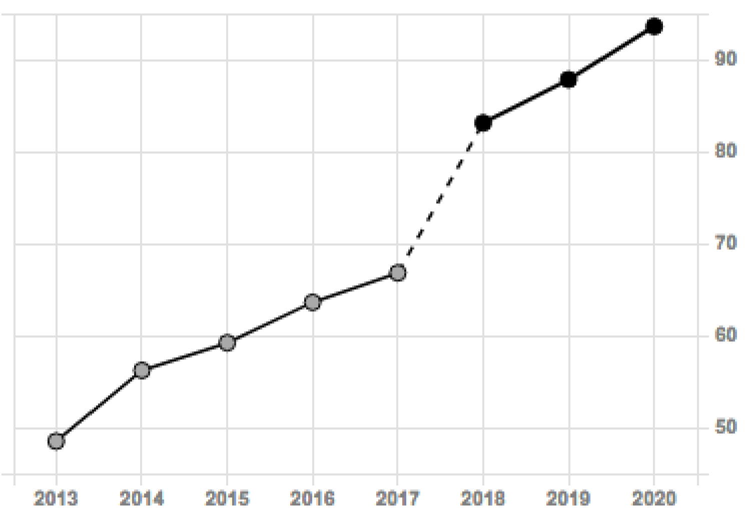
£ millions unless stated

Year	2018		2019		2020	
Turnover	479.0	+6.0%	499.1	+4.2%	524.9	+5.2%
EBITDA	88.3		93.0	+5.3%	98.6	+6.0%
EBIT	79.7		84.7	+6.2%	95.2	+12.4%
Pre-tax profit	83.1	+24.4%	87.8	+5.7%	93.6	+6.6%
Post-tax profit	59.4	+3.9%	63.8	+7.3%	68.3	+7.1%
EPS (p)	53.0	+4.8%	55.8	+5.3%	59.9	+7.3%
Dividend (p)	25.3	+10.0%	26.9	+6.3%	29.1	+8.2%
CAPEX	5.5		5.3	-3.7%	5.2	-1.0%
Free cash flow	55.7		61.3	+10.1%	68.8	+12.1%
Net borrowing	-49.6		-82.1	+65.3%	-117.1	+42.7%
NAV	291.8		319.0	+9.3%	347.7	+9.0%
Like for like sales growth %	-		-		-	

PRE-TAX PROFIT

£

Target price
Turnover
EBITDA
EBIT
Pre-tax profit
Post-tax profit
EPS
Dividend
CAPEX
Free cash flow
Net borrowing
NAV
LFL Sales %



The benefits of the weak pound are wearing off and I'm not sure that some investors have woken up to this yet. Going forward, growth looks like it is going to be quite hard to achieve for many businesses and those that do grow are likely to do so quite modestly.

Current forecasts for Diploma are for 4.8% growth in EPS to 53p in 2018. Analysts are still expecting a very high conversion of profits into free cash flow and a rapidly rising net cash balance.

At 1202p, the shares are on 22.7 times forecast EPS or 21.9 times adjusting for the forecast net cash balance of £49.6m. As the high-quality business that Diploma is, that looks pretty full in the absence of forecast upgrades.

Avon Rubber (LSE:AVON, Market Cap: £359m)

Disclosure: I currently own shares in Avon Rubber.

My main interest in this company is the protection business. It makes protection masks and breathing apparatus that are sold to military customers, police forces and fire services.

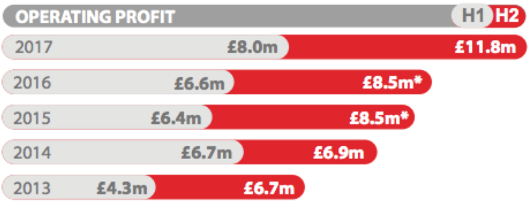
This kind of business has some very desirable characteristics in my opinion. As the products are safety and performance critical the standards set by buyers are very high and strict. This creates a barrier to entry and reduces competition. Once a company is on the preferred supplier list it tends to stand a good chance of maintaining and growing its business. If you are not on the list you can't compete.

Avon Protection

FINANCIALS

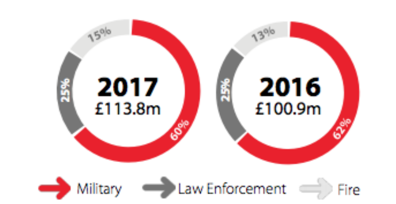
	2017	% Change	% Constant Currency
Orders received	£123.9m	24.3%	14.6%
Closing order book	£30.5m	45.9%	50.0%
Revenue	£113.8m	12.8%	3.6%
Adjusted EBITDA	£27.1m	26.0%	16.6%
Adjusted EBITDA margin	23.8%	2.5%	-
Adjusted operating profit	£19.8m	31.1%	22.2%

OPERATING PROFIT



* Restated

REVENUE SPLIT BY MARKET



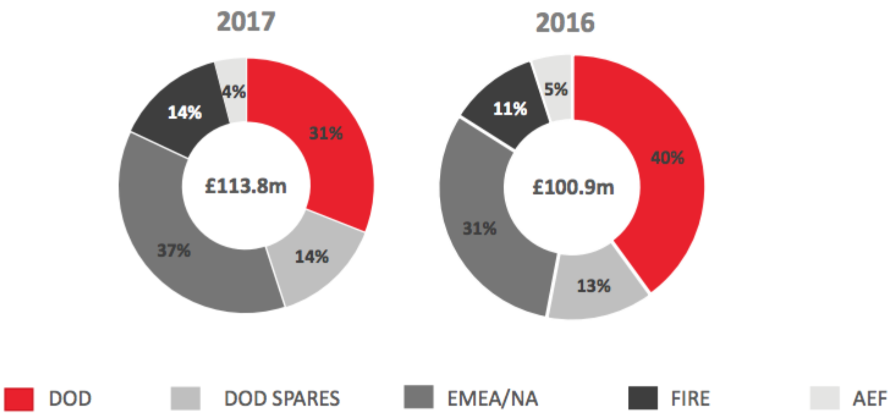
COMMENTS

- Strong growth in Fire across the whole portfolio
- Law Enforcement growth driven in North America
- Military revenue flat at constant currency
- Improved product mix drives 23.8% EBITDA margin – up 250 bps
- Closing order book provides good visibility into 2018

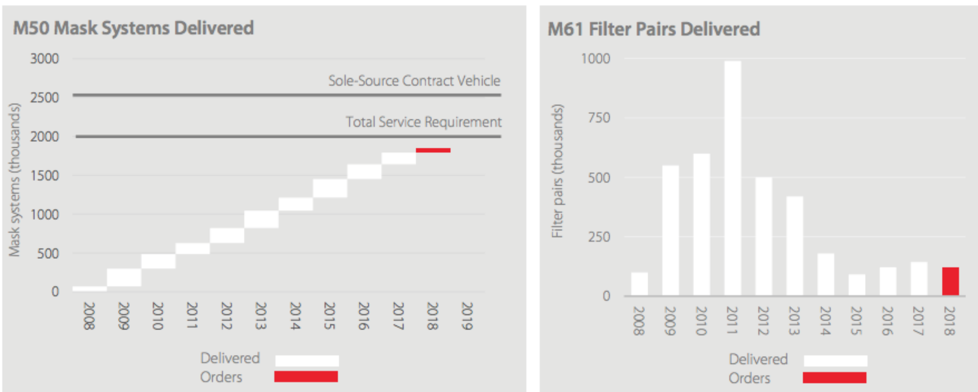
Avon's Protection business had a very good 2017 with strong growth in orders, revenues, profits and margins. The closing order book was also up strongly.

The US Department of Defense (DoD) is its biggest customer but growth here is muted due to the winding down of the M50 mask and M61 filter spares contracts shown in more detail below.

Avon Protection - Revenue Split



Avon Protection – M50 Masks and M61 Filter Pairs



Good growth is coming from the Fire business across America and the growth prospects here look to be pretty decent albeit at a more modest rate than was seen in 2017. Going forward, new contracts with the UK military will offset the maturing DoD contract and is expected to boost margins.

Further growth over the medium term is likely to come from new products being introduced to the portfolio of protection products. There is also a reasonable opportunity to increase the customer base within the law enforcement segment.

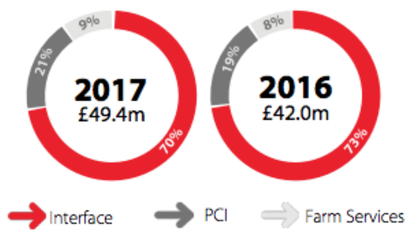
I am less excited about the company's milk machines and servicing business but it is by no means a shabby one. It has the attraction of high profit margins as well and looks set to deliver some growth due to the rising price of milk boosting the fortunes of its dairy farmer customers.

milkrite | InterPuls

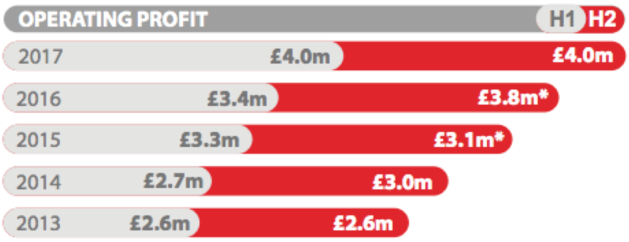
FINANCIALS

	2017	% Change	% Constant Currency
Orders received	£50.0m	17.4%	8.5%
Closing order book	£3.5m	40.0%	20.1%
Revenue	£49.4m	17.6%	6.6%
Adjusted EBITDA	£10.9m	11.2%	4.7%
Adjusted EBITDA margin	22.1%	(1.2%)	-
Adjusted operating profit	£8.0m	11.1%	5.8%

REVENUE SPLIT BY MARKET



OPERATING PROFIT



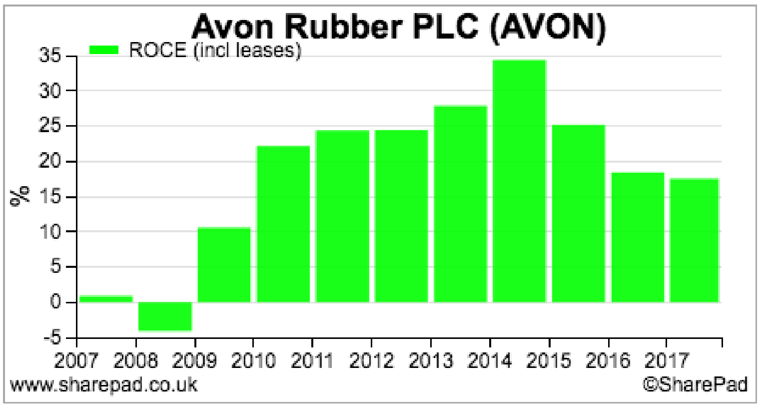
* Restated

COMMENTS

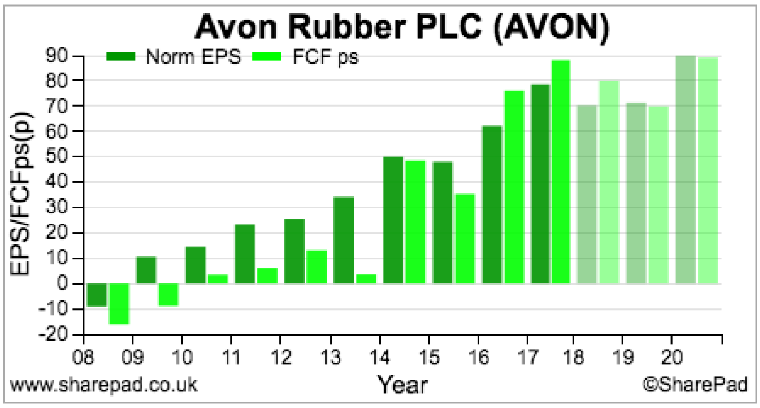
- Positive market conditions continue
- Strong growth across all markets
- Strong recovery in PCI
- Margins reflect investment to drive growth
- Farm Services expansion into pulsators and tags

Avon's business quality shows itself in very decent ROCE and excellent free cash generation which is expected to continue.

Analysts' forecasts for this share make for interesting reading at the moment. Profit growth is expected to be quite muted which seems at odds with the reasonably upbeat outlook from the company. This is especially true as the company is guiding towards flat military sales at a higher profit margin in 2018.



It is possible that analysts have not yet got round to revising their published forecasts after the results. Forecasts for 2020 look like a bit of an outlier at the moment as well so I'd take those with a pinch of salt. That said, it may reflect the new UK military contract having an effect.



With strong free cash flows and net cash on the balance sheet as well as a manageable pension deficit the company has made no secret of its desire to make acquisitions which enhance value for shareholders. It's always encouraging to hear of such intent but I don't think this should command anything extra on the current share price.

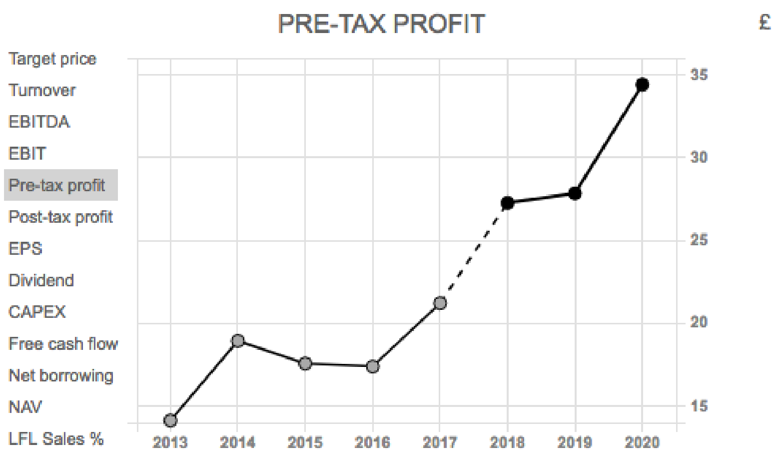
Avon Rubber PLC (AVON)

Opinion		Brokers	
1	Buy	7	
2	Out perform	0	
3	Hold	0	
4	Under perform	0	
5	Sell	1	
0	No opinion	1	Not included in consensus
1.5	**Buy**	**9**	**Consensus**

FORECASTS

£ millions unless stated

Year	2018		2019		2020	
Turnover	168.5	+3.3%	173.1	+2.7%	184.1	+6.4%
EBITDA	38.1	+15.3%	38.3	+0.6%	43.3	+13.1%
EBIT	27.5	+39.1%	27.8	+1.0%	34.2	+23.0%
Pre-tax profit	27.3	+28.6%	27.8	+2.1%	34.4	+23.6%
Post-tax profit	22.3	-7.5%	22.0	-1.3%	27.5	+25.0%
EPS (p)	70.3	-10.7%	71.3	+1.4%	89.9	+26.1%
Dividend (p)	15.5	+25.8%	18.2	+17.4%	27.1	+48.9%
CAPEX	4.0	-27.3%	4.3	+6.3%	3.5	-17.6%
Free cash flow	24.5	-9.3%	21.4	-12.6%	27.3	+27.4%
Net borrowing	-42.5	+72.1%	-49.1	+15.6%	-85.7	+74.5%
NAV	67.8	+21.9%	81.4	+20.1%	-	
Like for like sales growth %	-		-		-	



Another added attraction I see with Avon is that it looks like it has become quite a significant dividend payer and income share. The payout ratio is currently extremely low and the company has stated its intention to reduce dividend cover to two times from over six times currently:

"Our policy is to maintain a progressive dividend policy balancing dividend increases with the rates of adjusted earnings per share growth achieved, taking into account potential acquisition spend and the Group's financing position. Over recent years, we have grown the dividend per share by 30% per annum and we expect to continue to grow dividends ahead of earnings over the medium-term. Our policy is to maintain dividend cover (the ratio of dividend per share to adjusted earnings per share) above two times. This year dividend cover was 6.7 times (2016: 7.6 times). Once dividend cover has reduced to two times we intend to increase dividends in line with the growth in adjusted earnings per share."

As long as trading remains good, investors should expect very strong rates of dividend growth from the shares over the next few years which could produce a very nice boost to shareholder returns.

Just as an example, two times dividend cover on current forecasts would give a dividend per share of 35p and a yield of 3% at a share price of 1162p.

I think Avon Rubber is a pretty decent business and one that can still be bought for a reasonably modest rating of just over 16 times rolling one year EPS forecasts. Granted there is some fog on current forecasts but this is a share I am happy to tuck away for a few years.

Talk Talk Telecom (LSE:TALK, Market Cap £1.5bn)

Selling phone, broadband, mobile and TV services is a fiercely competitive business. It is also one that Talk Talk has struggled to get to grips with in recent years. Not only has the company created lots of problems for itself - particularly in the area of customer service - but it has also been up against competitors such as BT and Sky that have been able to woo many customers with attractive bundled deals known as quad play (Phone, broadband, mobile and TV).

Under its previous management team, the Talk Talk investment case was based on aggressive cost cutting and selling very cheap services in order to fund a dividend it ultimately could not afford.

The new management team is following a similar path and has cut the dividend to give it some breathing space. It seems that the stock market was not particularly impressed with what it saw in last week's half year results with Talk Talk shares falling sharply to a five year low.

The company added 46,000 net new customers (new ones less leavers) but revenue and profits are still shrinking and cash flow was still quite weak on an underlying basis.

The company is talking about a good response to its fixed low price plans where the price is fixed for the duration of the contract - with many customers signing up for two years and quite a few of them taking higher margin fibre broadband services.

This is a start but it has to lead to revenue-based profit growth ultimately to create a sustainable investment case for the shares in my view.

	30 September 2017 Unaudited	30 September 2016 Unaudited (restated)(4)
Revenue (GBPm)	856	902
EBITDA (GBPm)	29	119
Operating (loss)/profit (GBPm)	(42)	44
(Loss)/profit before taxation (GBPm)	(75)	30
(Loss)/profit after taxation (GBPm)	(71)	21
Basic EPS (p)	(7.5)	2.2
Cash flow (GBPm)	Six months ended 30 September 2017 Unaudited	Six months ended 30 September 2016 Unaudited (restated)(4)
Headline operating cash flow (1)	46	(28)
Interest and taxation	(28)	(11)
Headline free cash flow	18	(39)
Exceptional items	(21)	(15)
Acquisitions	(5)	(14)
Dividends	(47)	(100)
Headline net debt (3)	(837)	(847)
Headline net debt/EBITDA (3)	2.88x	2.51x

I do however see one scenario where Talk Talk could actually prosper. Both BT and Sky are about to bid for the next round of Premier League football rights. Should they have to shell out more money to retain their existing packages then I think they will find it very difficult not to increase prices - perhaps quite significantly.

This could see some disenchanted customers at Talk Talk's door but it is by no means certain. BT customers who do not want to pay for sport can trade down to its budget brand Plusnet if they want a no-frills package.

One thing that does concern me about this company is that it talks about EBITDA a lot. This to me is not very sensible. Telecoms businesses such as Talk Talk which owns a physical network are by their nature capital intensive. Money needs to be spent to keep the network in good working order.

EBITDA is therefore not an amount of money that can be paid out to shareholders. This is a long-held gripe of mine and I am constantly amazed that companies and investors go on about it so much still.

Looking at consensus forecasts for the company in the context of an unexceptional first six months I do find myself querying them.

The aforementioned EBITDA guidance is at the lower end of the £270m to £300m range. That looks OK given consensus of £266.4m.

I do have some questions on a free cash flow forecast of £138.6m given an actual free cash outflow of £4m during the first half of the year. This is not a particularly seasonal business which is why I am a little perplexed as to why the second half of the year should see this business being so cash generative.

TalkTalk Telecom Group PLC (TALK)

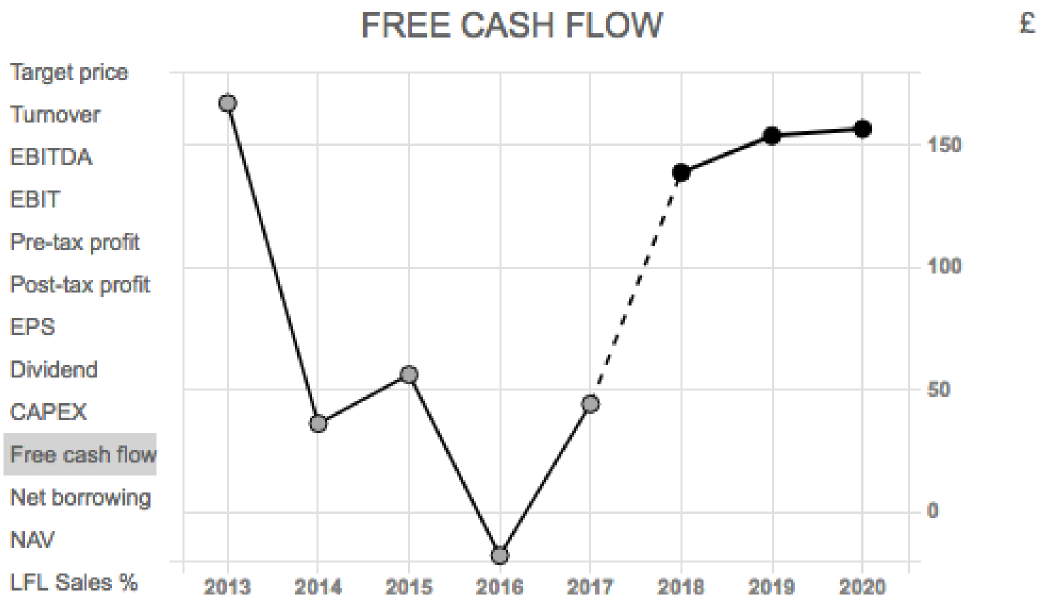
BREAKDOWN

Opinion		Brokers	
1	Buy	4	
2	Out perform	0	
3	Hold	4	
4	Under perform	7	
5	Sell	5	
0	No opinion	0	Not included in consensus
3.45	**Hold**	**20**	**Consensus**

FORECASTS

£ millions unless stated

Year	2018		2019		2020	
Turnover	1,736.2	-2.6%	1,813.7	+4.5%	1,850.2	+2.0%
EBITDA	266.4	-24.7%	305.7	+14.7%	308.7	+1.0%
EBIT	135.8	-36.2%	175.5	+29.2%	175.4	-0.0%
Pre-tax profit	80.0	-55.8%	137.6	+72.0%	142.0	+3.2%
Post-tax profit	69.1	-60.7%	113.8	+64.5%	116.9	+2.7%
EPS (p)	6.9	-62.3%	11.4	+65.2%	12.1	+6.1%
Dividend (p)	7.6	-26.1%	8.2	+7.9%	7.7	-6.1%
CAPEX	120.5	-21.2%	126.8	+5.2%	125.4	-1.1%
Free cash flow	138.6	+215.1%	153.6	+10.8%	156.5	+1.9%
Net borrowing	798.6	+2.1%	749.5	-6.1%	701.1	-6.5%
NAV	144.0	+2.9%	176.0	+22.2%	-	
Like for like sales growth %	-		-		-	



However, I will concede that analysts who follow this business full time are going to have a better feel for things than me. On that basis, the outlook for free cash flow looks very reasonable and is very supportive of a 7.6p dividend payment and a prospective dividend yield of 4.8% at a share price of 146p.

But you might want to ask yourself why you would want this yield when you can get a higher one from other stock exchange-listed telecom companies.

SharePad's enhanced forecast data now means that users can get forecasts for free cash flow dividend cover for three years. The table below shows that on the basis of current forecasts higher yields are on offer and are covered by expected free cash flow.

Of course, forecasts are often wrong but if these are vaguely accurate then perhaps income seekers can do better from owning other telecom shares than Talk Talk.

Name	**fc Yield**	2y fc Yield	3y fc Yield	fc FCF div cover	2y fc FCF div cover	3y fc FCF div cover
BT Group PLC	6.3	6.6	6.6	1.6	1.7	1.7
Manx Telecom PLC	5.9	6.1	6.3	1.2	1.1	1.4
Vodafone Group PLC	5.6	5.7	6.0	1.2	1.3	1.3
TalkTalk Telecom Group PLC	4.8	5.2	4.9	1.9	2.0	2.1