Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

30th 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	7326.67	▼-1.22	▼-2.15	▲8	7562.28	6730.72	6/11/17	2/12/16
2	FTSE 250	19952.9	▼-0.266	▼-1.29	▲13.7	20472.4	17435.3	3/11/17	2/12/16
3	FTSE SmallCap	5755.51	▼-0.324	▼-1.37	▲16.9	5892.71	4907.17	3/11/17	2/12/16
4	FTSE AIM 100	5280.49	▼-0.405	▼-1.2	▲34.3	5377.07	3869.3	7/11/17	6/12/16
5	FTSE All-Share	4035.01	▼-0.992	▼-1.94	▲9.28	4156.95	3665	3/11/17	2/12/16
6	S&P 500	2626.07	▲1.12	▲2.07	▲19.4	2627.04	2191.08	28/11/17	1/12/16
7	Brent Oil Spot $	$62.635	▼-1.25	▲3.45	▲21.6	$64.08	$44.785	6/11/17	21/6/17
8	Gold Spot $ per oz	$1284.19	▼-0.562	▲0.543	▲9.52	$1349.10	$1128.22	7/9/17	15/12/16
9	GBP/USD - US Dollar per British Pound	1.35062	▲1.51	▲2.22	▲7.92	1.3591	1.20401	15/9/17	16/1/17
10	GBP/EUR - Euros per British Pound	1.1343	▲1.02	▲0.0176	▼-4.01	1.1972	1.0795	18/4/17	29/8/17

Top Risers

No.	TIDM	Name	%chg 1w
1	OCDO	Ocado Group PLC	▲44.5
2	FDL	Findel PLC	▲31.8
3	TPT	Topps Tiles PLC	▲23
4	HSS	HSS Hire Group PLC	▲17.3
5	CIR	Circassia Pharmaceuticals PLC	▲16.7
6	OTB	On The Beach Group PLC	▲14.1
7	TET	Treatt PLC	▲13
8	MARS	Marston's PLC	▲12.9
9	SGC	Stagecoach Group PLC	▲12
10	ENQ	EnQuest PLC	▲11.1

Top Fallers

No.	TIDM	Name	%chg 1w
1	CINE	Cineworld Group PLC	▼-15.6
2	GAW	Games Workshop Group PLC	▼-12.9
3	VED	Vedanta Resources PLC	▼-12.5
4	LMI	Lonmin PLC	▼-12
5	ACA	Acacia Mining PLC	▼-11.5
6	TNI	Trinity Mirror PLC	▼-11
7	HOC	Hochschild Mining PLC	▼-10.3
8	OXIG	Oxford Instruments PLC	▼-9.94
9	NANO	Nanoco Group PLC	▼-9.91
10	CLLN	Carillion PLC	▼-9.46

Patisserie Holdings (LSE:CAKE)

For me, Patisserie Holdings is a very good business. Its chain of posh cake and sandwich shops offering 'affordable treats' is proving to be very popular with consumers.

In many ways, this company seems very similar to the high street bakery chain Greggs (LSE:GRG). Both companies are vertically integrated and supply their shops with products made in their own bakeries across the country.

Both business models generate very respectable returns on capital employed (ROCE) albeit that Patisserie Holdings achieves its ROCE with much higher profit margins than Greggs. This is probably explained by the higher prices of goods sold in Patisserie's shops.

The investment case behind Patisserie Holdings is that it is a self-funded retail roll out. Its shops are very profitable almost immediately and produce lots of free cash flow. This cash is then reinvested into new shop openings to create more cash flow and so on.

Full year results released this week were very respectable. Sales increased by 9.7%, with pre-tax profits increasing by 17.1%. Cash generation remained very good with a healthy increase in trading cash flow leading to a healthy jump in the year-end cash balance from £13.2m to £21.5m.

The company met its target of opening 20 new stores and controlled cost increases from ingredients, wages and rents well and managed to increase its profit margins.

One of the problems facing investors in this company is that it does not disclose like-for-like sales figures which makes it difficult to judge the health or otherwise of the underlying business.

I have no doubt that if Patisserie can add a further 250 stores - from 199 now - earning a lease-adjusted ROCE of around 15% then the value of the company will increase significantly. What I would like a better feel of is how the existing store base is getting on.

Just as you can receive more interest by putting more money into a savings account you can increase profits by investing more money in new stores. There is nothing wrong with this as long as returns on new money invested are good but the hallmark of a very good retailer is one that can get more growth out of its existing assets.

I am not sure this is happening with Patisserie Holdings.

Patisserie Holdings Analysis (£'000s)

Sales	**H1**	**H2**	**2016**	**H1**	**H2**	**2017**
Patisserie Valerie	34,953	38,952	73,905	40,437	43,902	84,339
Druckers	6,851	6,459	13,310	7,009	6,050	13,059
Baker & Spice	2,231	2,470	4,701	2,374	2,364	4,738
Flour Power	1,830	1,854	3,684	1,795	1,839	3,634
Philpotts	4,903	5,341	10,244	4,732	5,451	10,183
Operating profit	**H1**	**H2**	**2016**	**H1**	**H2**	**2017**
Patisserie Valerie	6,575	7,238	13,813	7,823	8,444	16,267
Druckers	644	569	1,213	724	478	1,202
Baker & Spice	523	588	1,111	518	616	1,134
Flour Power	254	280	534	250	315	565
Philpotts	619	589	1,208	708	737	1,445
Sales growth	**H1**	**H2**	**2016**	**H1**	**H2**	**2017**
Patisserie Valerie				15.69%	12.71%	14.12%
Druckers				2.31%	-6.33%	-1.89%
Baker & Spice				6.41%	-4.29%	0.79%
Flour Power				-1.91%	-0.81%	-1.36%
Philpotts				-3.49%	2.06%	-0.60%
Profit margins	**H1**	**H2**	**2016**	**H1**	**H2**	**2017**
Patisserie Valerie	18.81%	18.58%	18.69%	19.35%	19.23%	19.29%
Druckers	9.40%	8.81%	9.11%	10.33%	7.90%	9.20%
Baker & Spice	23.44%	23.81%	23.63%	21.82%	26.06%	23.93%
Flour Power	13.88%	15.10%	14.50%	13.93%	17.13%	15.55%
Philpotts	12.62%	11.03%	11.79%	14.96%	13.52%	14.19%

The table above shows the sales and profit performance of all of Patisserie Holding's brands over the last couple of years. The sales and profit story is dominated by the Patisserie Valerie cake shops.

Sales growth moderated slightly during the second half of the year but there was a decent uplift in margins at Patisserie Valerie. There is no sales or profit growth at Druckers whilst Philpotts - premium sandwiches and salads - saw flat sales but a healthy increase in margins year on year.

The company has closed five shops where the leases had expired as they were no longer seen as being good locations. Patisserie Valerie's new shops in Ireland are doing well whilst Philipotts' Manchester store has got off to a good start. The company remains confident of adding 20 new stores per year for the foreseeable future.

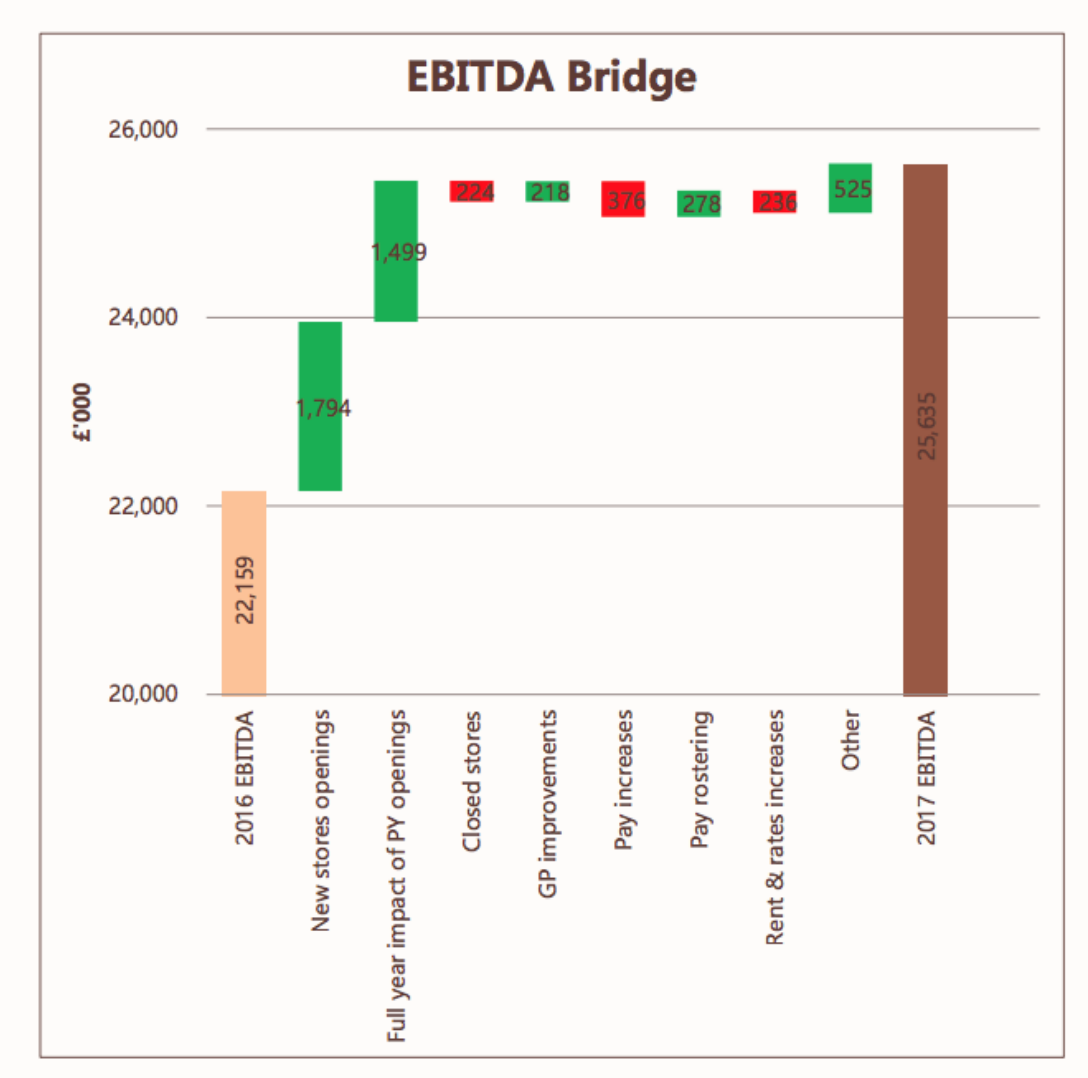
This is good news for investors as it seems underlying growth is quite weak.

Patisserie Valerie Estimated Sales and profit per store

According to my rough and ready calculations, average sales per store are not growing at Patisserie Valerie but profit per store did increase in 2017 as margins improved.

£000s	Sales per store	Profit per store
2017	587.7	113.4
2016	588.9	110.1

However, if we look at the improvement in EBITDA over the last year, you can see virtually all the growth came from new store openings and a full year effect of stores opened last year.



As I've already mentioned, the rollout is earning good incremental returns for shareholders. But if there is no underlying growth in the business then adding 20 new stores per year will slow the growth rate of sales and profits as the size of the business increases by an incrementally smaller amount each year.

The company is addressing this by selling cakes online and by trialling sales in Sainsbury's but at the moment the contribution to overall sales is small.

The shares have effectively been treading water for the last couple of years and have seen their valuation come down. Analysts' expectations for future sales growth look about right to me and at the moment upgrades look unlikely.

Patisserie Holdings Ltd (CAKE)

Opinion		Brokers	
1	Buy	5	
2	Out perform	1	
3	Hold	0	
4	Under perform	0	
5	Sell	0	
0	No opinion	0	Not included in consensus
1.17	Buy	6	Consensus

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	126.5	+10.7%	137.9	+9.0%	150.5	+9.1%
EBITDA	28.8		30.9	+7.4%	33.7	+9.0%
EBIT	23.0		25.1	+9.0%	27.6	+10.0%
Pre-tax profit	23.3	+15.4%	25.1	+7.8%	27.4	+9.3%
Post-tax profit	18.6	+13.7%	20.2	+8.6%	22.7	+12.5%
EPS (p)	18.6	+14.8%	19.9	+7.0%	21.8	+9.5%
Dividend (p)	4.1	+13.9%	4.7	+14.6%	5.3	+12.8%
CAPEX	9.0		9.5	+5.6%	9.3	-1.6%
Free cash flow	16.3		16.4	+0.3%	18.8	+15.0%
Net borrowing	-32.9		-44.9	+36.5%	-57.8	+28.5%
NAV	106.9		-		-	
Like for like sales growth %	-		-		-	

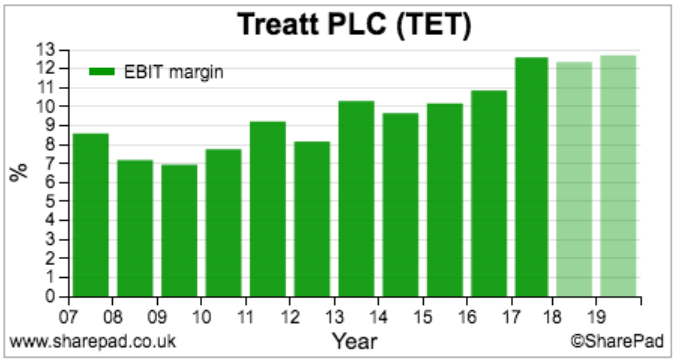
Free cash generation looks set to remain impressive and contribute to an increasing net cash balance. The company may come under pressure to do something with this either in the form of acquisitions, bigger dividends or share buybacks.

I think this is a nice business which should see long-term investors do alright. At 359p, the shares trade on 19.3 times 2018F EPS or 17.5 times if the expected net cash balance of £32.9m is adjusted for. That's not unreasonable given the returns the rollout is currently producing. I would be more bullish on the shares if there were signs of stronger underlying sales growth which would turbo-charge the rollout.

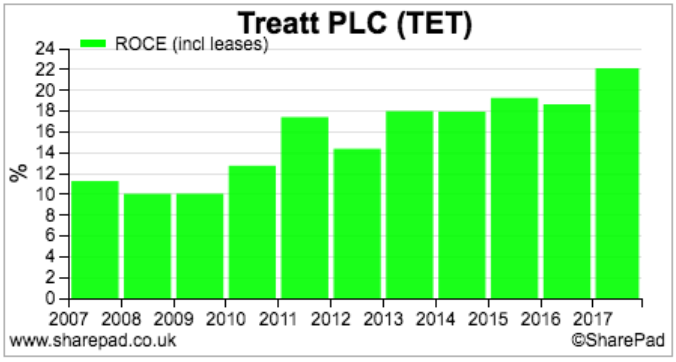
Treatt (LSE:TET)

2017 has been a stunning year for Suffolk based ingredients manufacturer Treatt. With most of its sales made outside the UK it has been a major beneficiary of the fall in the value of the pound. That said, underlying sales growth of over 18% was pretty impressive as the company met its 2020 profit targets three years earlier.

Treatt has been steadily moving its flavouring products up the value chain and has been making major gains in the areas of citrus, tea and sugar reduction. It has been winning lots of new orders from big global consumer drinks companies and has improved its profit margins and ROCE.



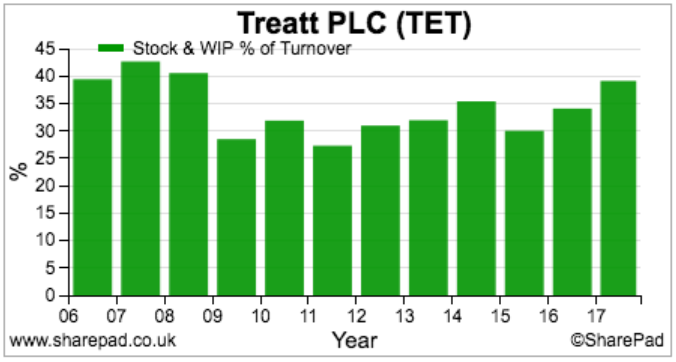
Underlying ROCE is now at 22% which is a sign that Treatt is a very good business indeed in terms of making money for shareholders. The big question is can it stay that way?



What is even more impressive about Treatt's ROCE is that it holds huge amounts of stocks in order to secure its supplies of natural ingredients and an uninterrupted supply of products to its customers. But holding 40% of annual sales in the form of stocks and work in progress just feels horrible to me.

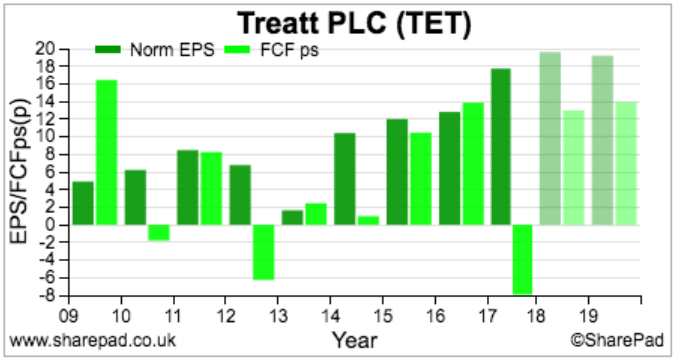
This is part and parcel of Treatt's business model and as an outsider I've no idea if it could manage with lower stocks. I'll have to assume that it cannot as I fail to see why any rational management team would have such high stock levels by choice.

A big buildup in stocks was the only major disappointment of the 2017 results as they caused a £13m cash outflow and led to a significantly negative free cash flow per share.



Some of the outflow was for good reasons in the form of a higher order book but I have to say that this is one characteristic of Treatt that I am not too keen on.

To me it seems that Treatt's stunning profitability has been significantly helped by high capacity utilisation of its manufacturing plants in the UK and USA which has geared up profits to the rise in sales.

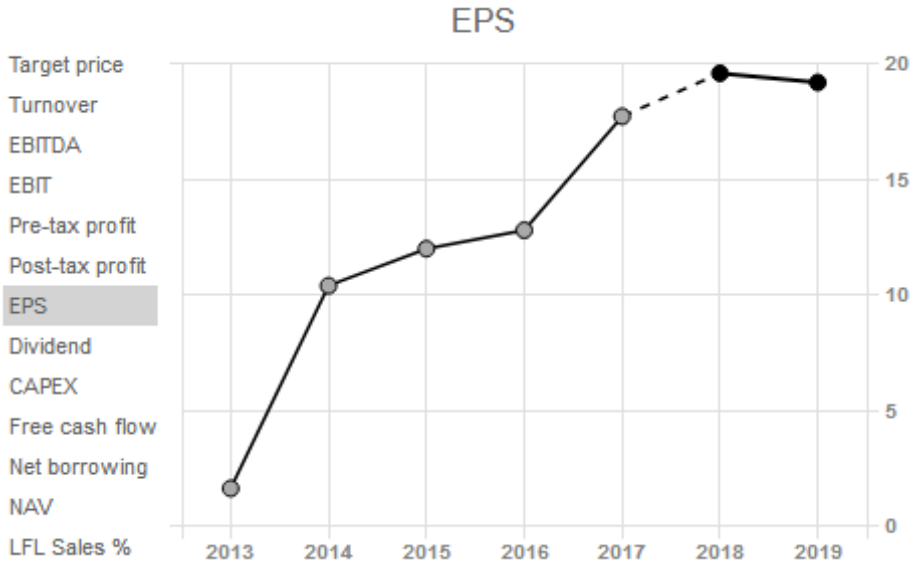


However, the value of Treatt's old UK facility in Bury St Edmunds is on the balance sheet for way below its replacement cost. The company is moving to a new site for a cost of £35m and is spending $14m to increase capacity at its plant in Florida. This is an interesting lesson for anyone judging a company on a measure such as ROCE as ageing assets can overstate the realistic expected returns when they are replaced.

Investing to deliver growth is what most shareholders of businesses want to see but new money spent has to earn acceptable returns in the form of extra profits and cash flows.

Over the next two to three years, Treatt's invested capital in its business looks set to increase by around two thirds but its profits are not predicted to grow by anywhere near that much. I think it's unfair to expect a company to earn very high returns on new production facilities in the first couple of years and that investors should wait at least five years before judging whether the increased investment has paid off.

I like what Treatt is doing with its business. Its focus on citrus, tea and sugar reduction is tapping into a strong trend amongst big drinks and consumer goods companies. It would not surprise me to see analyst forecasts nudge up for this share.



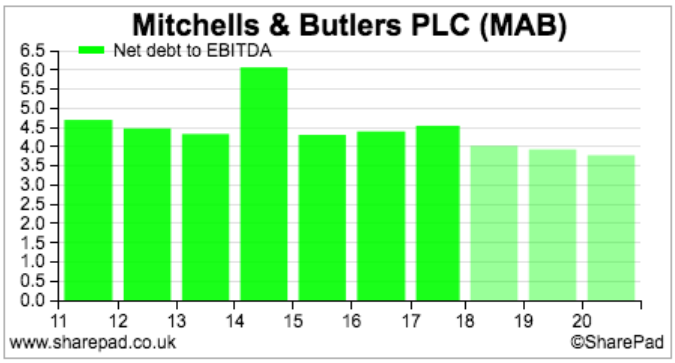
However, I do feel that the company could have been a bit more forthcoming with more details on its new five year strategy out to 2022. Some profit targets would undoubtedly have been welcomed by investors but very little has been revealed.

If forecasts do not move upwards then the current valuation of just over 23 times 2018F EPS looks like it is pricing in a reasonable amount of future growth already.

Mitchells & Butlers (LSE:MAB)

It's putting it mildly to say that pub group Mitchells & Butlers is in a bit of a mess. Full year results for the year to September made for pretty grim reading. Profits were down, the value of some pubs were reduced and the kick in the teeth was the scrapping of the dividend payment for the first half of the new financial year.

The company has been fighting battles for many years. It is still burdened with a massive debt pile from financial engineering of its tenanted pubs business a decade ago. Its balance sheet is more like a regulated utility's than what would be more sensible for a consumer-facing business.



This is not ideal when you are operating in a market with too many pubs and restaurants chasing too few customers. In its full year results statement the company refers to a competitive market and increased discounting and uses this as justification to move its pubs more upmarket.

The problem is that these shifts in customer offerings are not feeding through to higher profits for the company as a whole and are costing a lot of money. The company has remodelled or converted 252 of its 1750 pubs this year as it brings down its pub redevelopment cycle from 11-12 years to 6-7 years.

The reduction in this cycle for pubs is concerning for investors as it is telling them that pubs are becoming more capital intensive. They need more money spent on them more frequently to stay competitive.

	FY 2017		FY 2016	
	GBPm	#	GBPm	#
Maintenance and infrastructure	53		81	
Remodels - refurbishment	42	143	34	137
Remodels - expansionary	14	31	13	38
Conversions	39	78	31	77
Acquisitions - freehold	3	1	1	2
Acquisitions - leasehold	18	12	7	6
Total return generating capital expenditure	116	265	86	260
Total capital expenditure	169		167	

The company spent £95m on conversions and remodels in 2017 up from £78m in 2016. In terms of the return that money is generating it said:

"The EBITDA return across all conversion and acquisition capital invested since FY 2014 is 18%, with projects since the start of the financial year returning 22%. Recent remodel performance has been encouraging, delivering sales uplifts in excess of 10%."

I assume the EBITDA return is the extra EBITDA generated as a percentage of the money spent on remodels and conversions. The kind of numbers mentioned look good but are they really?

EBITDA return is a proxy for cash flow return on cash capital invested. This kind of return measure is used a lot by pub companies to convince investors - and perhaps themselves - that they are spending money wisely. I've nothing against using it but think it needs to be put into context with what the company is making as a whole.

At September 2016, the gross asset value of property plant and equipment (most of it pubs) was £5.04bn. This is the cash that has been spent on them before they are depreciated. Adjusting for additions, disposals and revaluations the total amount of cash capital invested was around £5.1bn at the end of September 2017.

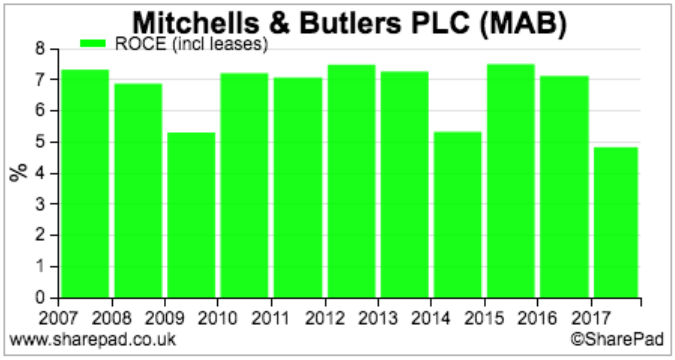
Adjusted EBITDA for 2017 was £429m for the whole group which gives an estimated cash return on cash capital invested of 8.4% - a far cry from the kind of figures being bandied around for returns on remodelling and conversion expenditure and is a really poor number in my opinion.

The other issue is how long those returns on remodels actually last. The company is saying that the refurbishment cycle is 6.7 years when it has to start spending money again to prevent sales and profits from falling.

This is the problem I have with using EBITDA in asset-intensive industries such as pubs. It ignores the fact that the assets have to be replaced. Highlighting EBITDA returns does not give the investor a real feel for the sustainable returns of the assets.

I prefer to use ROCE as at least some estimate of replacement cost is charged against revenues. On this measure, Mitchells & Butlers is making very poor returns on the money it invests.

The net asset value of £1.6bn on the balance sheet might be compared favourably with the company's market capitalisation of £1.1bn but I think that would be a mistake. In my opinion, a company needs to be making ROCE of at least 8-10% for the balance sheet value of its assets to be taken seriously. Regular impairments (reductions in value) are also a sign that the balance sheet values are questionable.



Interestingly, M&B's 2016 annual report says that the pub assets are valued using an estimate of future cash flows discounted at a pre-tax rate of interest of 7%. I think that rate is too low. It is effectively saying that an asset earning a 7% sustainable ROCE should not be revalued downwards. The stock market seems to be taking a different view - by valuing the equity of the company at a substantial discount to net asset value - and one that I am inclined to agree with.

Mitchells & Butlers PLC (MAB)

CONSENSUS — Last updated 28/11/17

SUMMARY	Consensus	Target price	Turnover	Pre-tax
	HOLD	-2.8%	-0.6%	+131%
	No Change	253.3p	£2.2b	£178.1m

BREAKDOWN

Opinion		Brokers	
1	Buy	1	
2	Out perform	2	
3	Hold	9	
4	Under perform	1	
5	Sell	2	
0	No opinion	0	Not included in consensus
3.07	Hold	15	Consensus

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	2,167.7	-0.6%	2,196.7	+1.3%	2,261.6	+3.0%
EBITDA	423.1	+7.1%	432.4	+2.2%	434.9	+0.6%
EBIT	307.9	+48.0%	309.3	+0.5%	317.2	+2.6%
Pre-tax profit	178.1	+134.4%	184.5	+3.6%	194.9	+5.6%
Post-tax profit	145.7	+135.0%	152.4	+4.6%	159.9	+5.0%
EPS (p)	33.7	+128.3%	35.0	+3.9%	36.9	+5.4%
Dividend (p)	7.3	-2.7%	7.4	+1.4%	7.6	+2.7%
CAPEX	180.5	+6.8%	191.4	+6.1%	190.0	-0.7%
Free cash flow	187.0	+228.1%	162.9	-12.9%	212.7	+30.6%
Net borrowing	1,701.5	-5.2%	1,699.1	-0.1%	1,642.7	-3.3%
NAV	-		-		-	
Like for like sales growth %	2.0		2.3	+12.5%	2.0	-11.1%

Sadly, I think this business has lots of problems. It also needs to get its debts down further. The ratio of net cash flow from operations to cash interest payable was an uncomfortable 2.8 times in 2017. Whilst the company will want to avoid tapping shareholders for a fresh injection of cash, it might be better for the long-term health of the business if it did.

Rail companies

TIDM	Name	Close	Market Cap. (m)	PE roll 1	fc Yield	%chg 2/1/17	% ch 29/11/17
FGP	FirstGroup PLC	110.3p	£1332.2	8.1	2.6	▲6.47	▲3.5
GOG	Go-Ahead Group (The) PLC	£16.00	£690.0	9.2	6.4	▼-28.6	▲0.95
SGC	Stagecoach Group PLC	180.8p	£1037.1	9.4	6.6	▼-16.4	▲13

Owning a rail franchise used to be seen as a good thing for a transport company as it used to produce a stream of growing profits and cash flows. This is no longer the case. In recent years they have often been a millstone around a company's neck and have caused some big headaches for companies.

Wednesday this week saw the government announce a strategic vision for rail. The big winner from this announcement seems to be Stagecoach. The government's decision to introduce a public private partnership for the East Coast Mainline from 2020 may remove a lot of the potential losses from the company's contract that was due to run until 2023.

In so doing, it removes some risk of a potential dividend cut. Stagecoach's shares have been battered but could rally quite hard even following a 13% bounce on the day of the government's announcement.