Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

15th December 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	7448.12	▲1.74	▲0.455	▲7.18	7562.28	6949.19	6/11/17	14/12/16
2	FTSE 250	20006.3	▲0.989	▲0.805	▲13.1	20472.4	17682.4	3/11/17	14/12/16
3	FTSE SmallCap	5758.94	▲0.538	▼-0.437	▲14.4	5892.71	5034.86	3/11/17	14/12/16
4	FTSE AIM 100	5200.94	▲0.266	▲0.135	▲31.2	5377.07	3956.39	7/11/17	15/12/16
5	FTSE All-Share	4088.58	▲1.57	▲0.479	▲8.38	4156.95	3772.28	3/11/17	14/12/16
6	S&P 500	2662.37	▲0.963	▲3.24	▲18.2	2664.11	2238.83	12/12/17	30/12/16
7	Brent Oil Spot $	$62.8005	▲1.14	▲2.06	▲16.9	$64.745	$44.785	11/12/17	21/6/17
8	Gold Spot $ per oz	$1254.44	▲0.583	▼-2.07	▲9.75	$1349.10	$1128.22	7/9/17	15/12/16
9	GBP/USD - US Dollar per British Pound	1.34372	▼-0.337	▲2.13	▲7.19	1.3591	1.20401	15/9/17	16/1/17
10	GBP/EUR - Euros per British Pound	1.14025	▼-0.441	▲2.19	▼-4.38	1.1972	1.0795	18/4/17	29/8/17

Top Risers

No.	TIDM	Name	%chg 1w
1	LMI	Lonmin PLC	▲31.3
2	DC.	Dixons Carphone PLC	▲15.1
3	GAW	Games Workshop Group PLC	▲13.8
4	HIK	Hikma Pharmaceuticals PLC	▲13.4
5	FOXT	Foxtons Group PLC	▲12.5
6	IRV	Interserve PLC	▲12.5
7	VEC	Vectura Group PLC	▲12.3
8	MOTR	Motorpoint Group PLC	▲12.2
9	ZTF	Zotefoams PLC	▲12.2
10	EVR	Evraz PLC	▲10.5

Top Fallers

No.	TIDM	Name	%chg 1w
1	HSS	HSS Hire Group PLC	▼-15.9
2	CPI	Capita PLC	▼-14.1
3	CMBN	Cambian Group PLC	▼-13.2
4	SAGA	Saga PLC	▼-10.9
5	DIA	Dialight PLC	▼-10.7
6	GEMD	Gem Diamonds Ltd	▼-10.4
7	GMS	Gulf Marine Services PLC	▼-9.62
8	KMR	Kenmare Resources PLC	▼-9.6
9	NOG	Nostrum Oil & Gas PLC	▼-9.52
10	WG.	Wood Group (John) PLC	▼-8.88

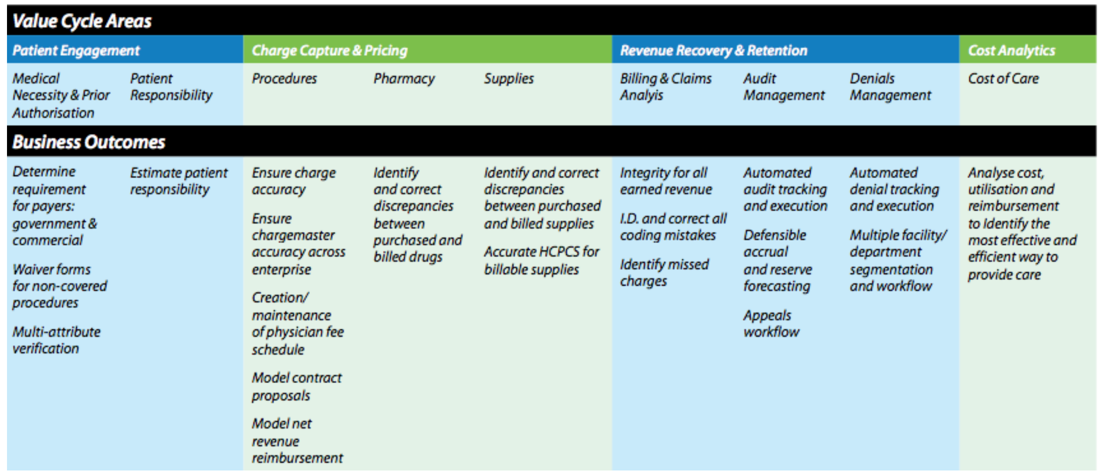
Craneware (AIM:CRW)

Software companies can be very profitable businesses if they have a popular product. Money is spent developing products but if the company can sell lots of them the returns on investment and profit margins can be very impressive.

This has been the case for AIM-listed Craneware which sells a variety of software products to US hospitals. They are designed to improve the operational and financial performance of hospitals in a changing and challenging US healthcare market that is putting lots of pressure on costs.

The company also sells products which are designed to help patients who are increasingly responsible for paying more of their bills as healthcare insurance policies become less generous.

The range of products and what they do is summarised in the table below.

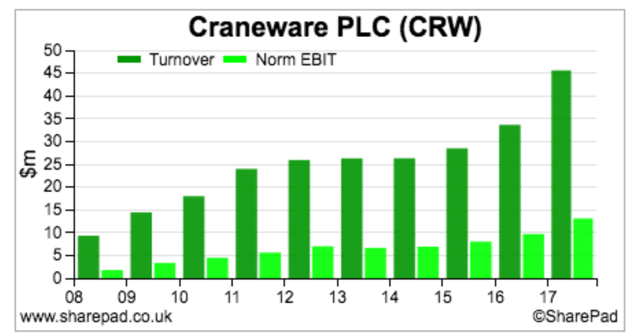


Value Cycle Areas								
Patient Engagement		Charge Capture & Pricing			Revenue Recovery & Retention			Cost Analytics
Medical Necessity & Prior Authorisation	Patient Responsibility	Procedures	Pharmacy	Supplies	Billing & Claims Analyis	Audit Management	Denials Management	Cost of Care
Business Outcomes								
Determine requirement for payers: government & commercial Waiver forms for non-covered procedures Multi-attribute verification	Estimate patient responsibility	Ensure charge accuracy Ensure chargemaster accuracy across enterprise Creation/ maintenance of physician fee schedule Model contract proposals Model net revenue reimbursement	Identify and correct discrepancies between purchased and billed drugs	Identify and correct discrepancies between purchased and billed supplies Accurate HCPCS for billable supplies	Integrity for all earned revenue I.D. and correct all coding mistakes Identify missed charges	Automated audit tracking and execution Defensible accrual and reserve forecasting Appeals workflow	Automated denial tracking and execution Multiple facility/ department segmentation and workflow	Analyse cost, utilisation and reimbursement to identify the most effective and efficient way to provide care

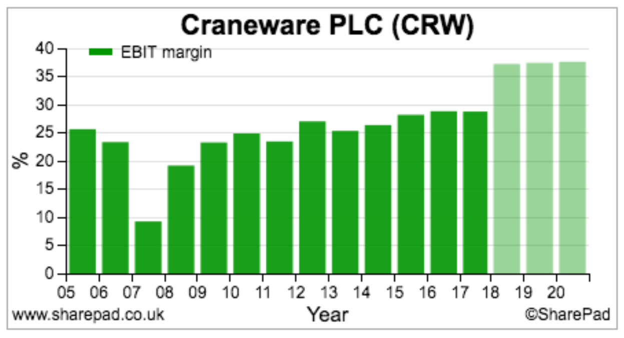
My summary of what their products do is as follows:

- Help hospitals collect money owed and avoid bad debts.
- Determine whether money should be spent; what is really needed for the diagnosis or treatment of an illness and what an insurance policy will cover.
- Accurate charging and pricing of services.
- Estimated patient bills, payment plans and options.
- Claims analysis.
- Cost analysis to work out the most cost-effective treatment plans.

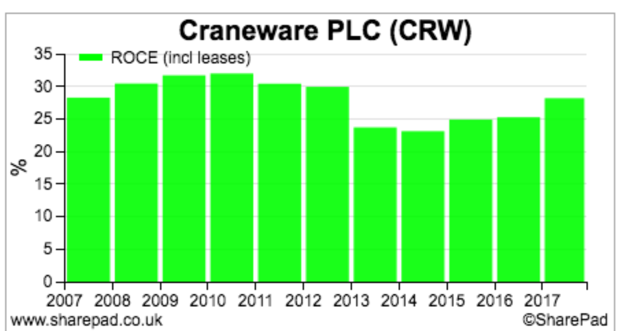
Craneware's software products are used under licence which typically lasts for five years. The company also makes money from selling professional advisory services which usually occur in the first year of a contract.



The company has done a pretty good job of selling more products which has allowed it to deliver decent rates of sales and profits growth over the last few years.



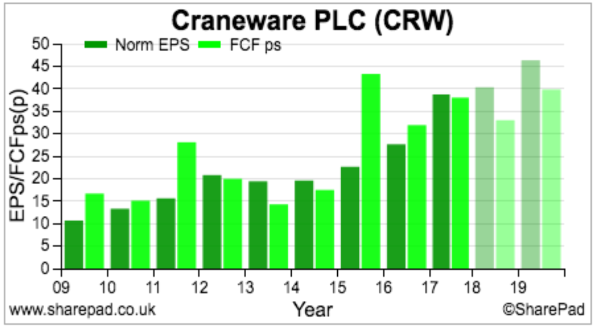
It has also achieved very high profit margins in doing so. This has fed through to very impressive returns on capital employed (ROCE).



The company has also been good at turning its profits into free cash flow which is a good sign. This is a function of its subscription business model - where customers pay in advance for their and the low ongoing capital requirements of the business.

Craneware seems to tick a lot of boxes in meeting the criteria of a high-quality business which can explain why its shares are currently highly valued by the stock market. That said, these kinds of businesses have disappointed investors in the past. The key areas to

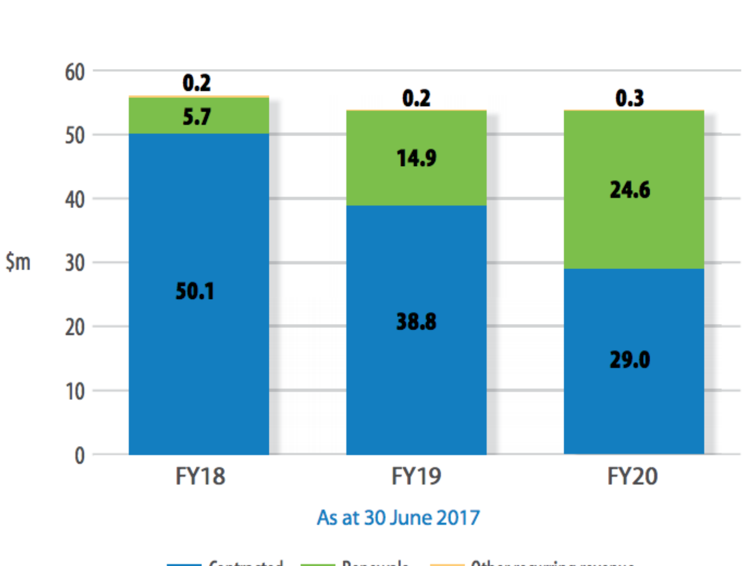
scrutinise in my opinion are the recognition of revenues - when a sale is booked - and the treatment of development costs – i.e. whether they are expensed against revenues in the year they are incurred or put on the balance sheet and spread over a number of years.



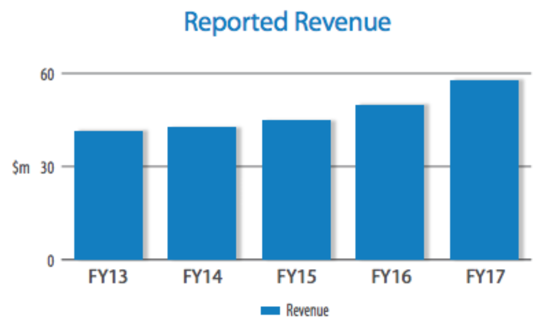
I don't think there is anything to worry about on revenue recognition. The company does receive money in advance but spreads it evenly over the contract as it is earned. The cash received in advance sits on the balance sheet as a deferred income creditor. This balance reduces every month over the length of the contract.

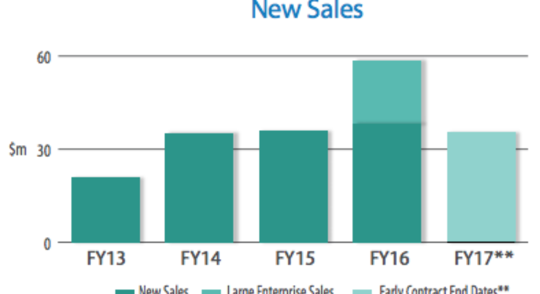
On a related matter, Craneware increasingly stresses the high visibility of its revenues that come from its subscription-based business model. It talks about its three year visible revenue in its annual report which shows the amount of contracted revenue and the amount of business that is up for renewal.

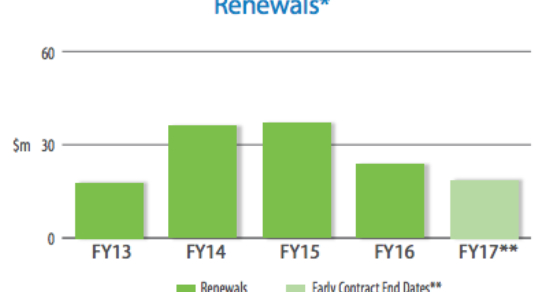
This kind of visibility is welcome but needs to be treated with caution as it assumes that all revenues due for renewal will be renewed. Historically, this has been the case but you can see from the chart above that a large chunk of business is up for renewal in 2020. This will not be a problem if it is renewed but does highlight that there is some revenue risk in this business.



The company also provides some useful information on the amount of new sales in the year and the level of renewals. Clearly, new sales are the key to keeping overall sales growing. As you can see from the chart below the level of new sales has plateaued.







One of the areas you should scrutinise in a software company is its treatment of software development costs associated with new products. The prudent approach is to charge all your costs against revenues but if a new product looks like it will be technically feasible and will end up as a saleable product then it is permissable to capitalise development expenditure. This means that the amount spent can be put on the balance sheet and spread over its useful life (amortised).

Craneware's policy on this is shown here states that it spreads development expenditure over five years.

(d) Research and Development expenditure

Expenditure associated with developing and maintaining the Group's software products is recognised as incurred. Where, however, new product development projects are technically feasible, production and sale is intended, a market exists, expenditure can be measured reliably, and sufficient resources are available to complete such projects, development expenditure is capitalised until initial commercialisation of the product, and thereafter amortised on a straight-line basis over its estimated useful life, which has been assessed as five years. Staff costs and specific third party costs involved with the development of the software are included within amounts capitalised.

There is nothing untoward about this but there is scope for this approach to be

abused. It means that costs such as wages can be put on the balance sheet rather than expensed through the income statement which will boost a company's profits (or reduce it's losses) at the expense of its free cash flow.

I think it's always a good idea to compare the amortisation expense of development against income with the amount of cash spent.

We can see here that Craneware has capitalised $9.2m of development costs on its balance sheet. It spent $3.5m in 2017 up from $2m in 2017. The amortisation expense in the income statement was $120,000 in 2017, down from $167,000 the year before.

14 Intangible assets

Goodwill and Other Intangible assets

Group	Goodwill $'000	Customer Relationships $'000	Proprietary Software $'000	Development Costs $'000	Computer Software $'000	Total $'000
Cost						
At 1 July 2016	11,438	2,964	3,043	5,755	993	24,193
Additions	-	-	-	3,482	443	3,925
At 30 June 2017	11,438	2,964	3,043	9,237	1,436	28,118
Accumulated amortisation						
At 1 July 2016	250	1,713	1,976	2,926	793	7,658
Charge for the year	-	329	-	120	166	615
At 30 June 2017	250	2,042	1,976	3,046	959	8,273
Net Book Value at 30 June 2017	**11,188**	**922**	**1,067**	**6,191**	**477**	**19,845**
Cost						
At 1 July 2015	11,438	2,964	3,043	3,796	912	22,153
Additions	-	-	-	1,959	207	2,166
Disposals	-	-	-	-	(126)	(126)
At 30 June 2016	11,438	2,964	3,043	5,755	993	24,193
Accumulated amortisation						
At 1 July 2015	-	1,384	1,058	2,759	756	5,957
Charge for the year	-	329	163	167	144	803
Impairment of acquisition	250	-	755	-	-	1,005
Amortisation on disposal	-	-	-	-	(107)	(107)
At 30 June 2016	250	1,713	1,976	2,926	793	7,658
Net Book Value at 30 June 2016	11,188	1,251	1,067	2,829	200	16,535

The table below shows the difference between the amortisation expense in the income statement and the amount capitalised on the balance sheet.

Year / $000s	Amortisation	Capitalised	Difference	Adj. EBITDA	Fully-expensed EBITDA	Difference
2017	120	3,482	3,362	18,002	14,520	-19.34%
2016	167	1,959	1,792	15,863	13,904	-12.35%
2015	302	761	459	14,356	13,595	-5.30%
2014	356	31	-325	13,069	13,038	-0.24%
2013	383	92	-291	12,357	12,265	-0.74%
2012	410	328	-82	11,932	11,604	-2.75%

I have also calculated what EBITDA would have been if development costs had been fully expensed rather than capitalised. You calculate this by subtracting the capitalised cost number away from the adjusted EBITDA figure (which includes the amortisation expense).

The treatment of research and development expenditure by companies is controversial and raises issues not only with software companies but also drug and engineering companies as well.

I can see the case for capitalisation of costs but also accept that there is some scope for aggressive accounting here. I am not saying that Craneware is up to no good here but as you can see there has been a big gap between capitalised and expensed costs during the last couple of years as it has been developing new products.

I think it is not a bad idea to see what profits would have been if development costs had been fully expensed. With Craneware, adjusted EBITDA would have been nearly 20% lower than reported in 2017. The rate of annualised growth would have been 4.4% compared with the reported 13.5%. Its five year EBITDA growth would be 25.1% compared with the 50.9% reported.

Here are a couple more interesting items of information I found from reading Craneware's annual report. The first is that despite selling its products to US hospitals it seems that most of its profits are booked in the UK - which means it benefits from a lower tax rate on these profits.

10 Tax on profit on ordinary activities

	2017 $'000	2016 $'000
Profit on ordinary activities before tax	**16,884**	13,923
Current tax		
Corporation tax on profits of the year	**3,463**	3,344
Foreign exchange on taxation in the year	**(65)**	54
Adjustments for prior years	**300**	(86)
Total current tax charge	**3,698**	3,312
Deferred tax		
Origination & reversal of timing differences	**(161)**	27
Adjustments for prior years	**(178)**	25
Change in tax rate	**-**	(16)
Total deferred tax charge	**(339)**	36
Tax on profit on ordinary activities	**3,359**	3,348

The difference between the current tax charge on ordinary activities for the year, reported in the consolidated Statement of Comprehensive Income, and the current tax charge that would result from applying a relevant standard rate of tax to the profit on ordinary activities before tax, is explained as follows:

	2017 $'000	2016 $'000
Profit on ordinary activities at the UK tax rate 19.75% (2016: 20%)	**3,335**	2,785
Effects of:		
Adjustment in respect of prior years	**122**	(61)
Change in tax rate	**-**	(16)
Additional US taxes on profits 39% (2016: 39%)	**209**	559
Foreign Exchange	**(65)**	54
Expenses not deductible for tax purposes	**(16)**	27
Deduction on share plan charges	**(226)**	-
Total tax charge	**3,359**	3,348

The second is that the finance director, despite being a board member since 2008 doesn't appear to own any shares in the company. Most investors like to see senior directors own a significant stake in the company. The CEO and founder still owns nearly 13% of the outstanding shares.

The company seems to be doing well and has recently announced a new contract win. It also has high hopes for its Trisus Enterprise Value Platform which will hopefully allow high rates of customer retention and the selling of additional products to customers.

It has also created a new business called Craneware Healthcare Intelligence that will analyse healthcare industry costs with the potential to provide additional revenue generating services.

City analysts are predicting strong level of sales and profit growth for the next few years with continued good rates of cash generation. At 1460p the shares trade on a punchy 2018 PE of 36.3 times. This falls to 32.1 times when adjusted for net cash balances. A lot of good news looks to be priced into the shares.

Craneware PLC (CRW)

BREAKDOWN

Opinion		Brokers	
1	Buy	2	
2	Outperform	0	
3	Hold	1	
4	Underperform	0	
5	Sell	0	
0	No opinion	0	Not included in consensus
1.67	**Outperform**	**3**	**Consensus**

FORECASTS

£ millions unless stated

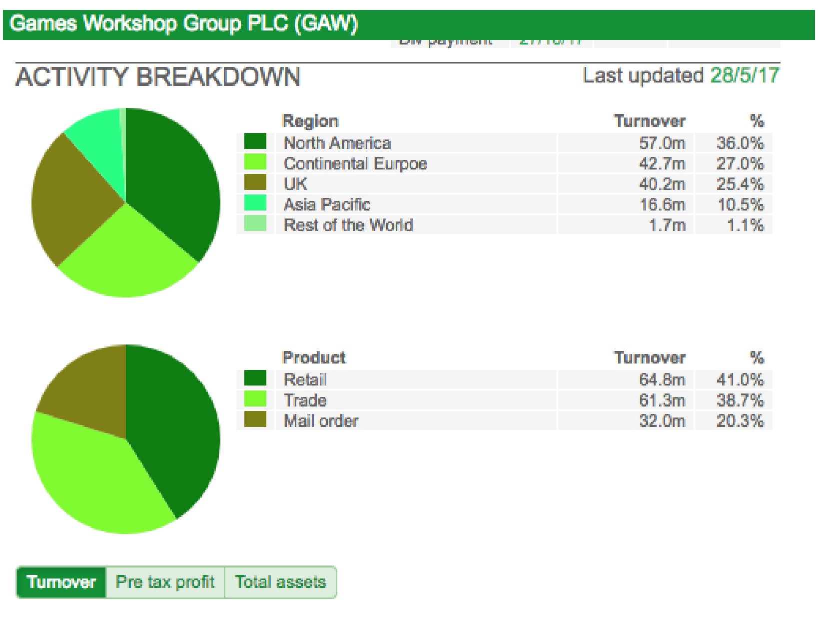
Year	2018		2019		2020	
Turnover	49.8	+9.3%	57.1	+14.7%	65.0	+13.8%
EBITDA	15.4	+10.1%	17.7	+15.3%	20.3	+14.3%
EBIT	13.9	+6.2%	16.1	+15.3%	18.4	+14.4%
Pre-tax profit	14.8	+11.2%	17.0	+14.9%	19.4	+13.9%
Post-tax profit	10.4	-2.4%	12.1	+15.8%	14.2	+17.4%
EPS (p)	40.2	+3.9%	46.2	+14.9%	52.7	+14.1%
Dividend (p)	22.3	+11.3%	23.8	+7.1%	27.0	+13.2%
CAPEX	-		-		-	
Free cash flow	9.1	-13.3%	10.9	+20.7%	13.3	+21.2%
Net borrowing	-45.1	+10.2%	-51.4	+14.0%	-59.2	+15.1%
NAV	-		-		-	
Like for like sales growth %	-		-		-	

Games Workshop (LSE:GAW)

Games Workshop has been one of the shares of 2017. Its share price has more than tripled during the year whilst the company has already declared 85p of dividends during the first seven months of its 2017/2018.

The company makes and sells fantasy miniature characters that are sold to collectors, for painting and to hobbyists and gamers. It is based in Nottingham and sells its products all over the world via its own network of stores, mail order and third party retailers. 75% of its sales were from outside the UK in 2016/17.

This is very much a niche business and is based on human interaction with its products and has very little to do with computers.



Games Workshop Group PLC (GAW)

ACTIVITY BREAKDOWN

Last updated 28/5/17

Region	Turnover	%
North America	57.0m	36.0%
Continental Eurpoe	42.7m	27.0%
UK	40.2m	25.4%
Asia Pacific	16.6m	10.5%
Rest of the World	1.7m	1.1%

Product	Turnover	%
Retail	64.8m	41.0%
Trade	61.3m	38.7%
Mail order	32.0m	20.3%

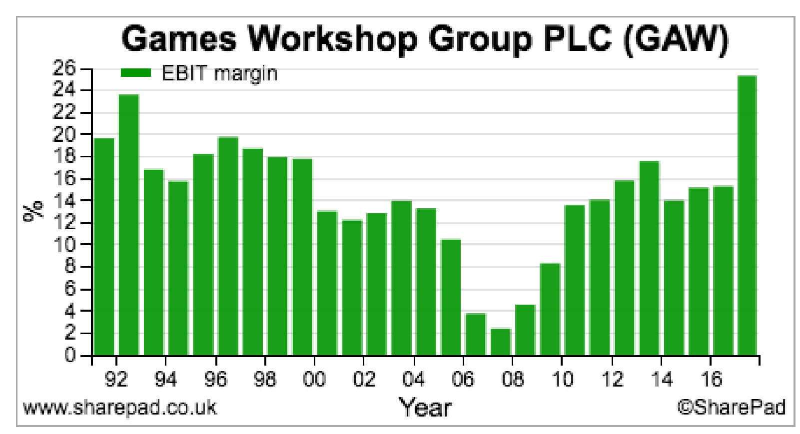
Turnover | Pre tax profit | Total assets

The company has stuck to what it does best over the years and has maintained a profitable niche with its high-quality figures. It has largely avoided the temptation to get sucked into the historical wargame figure market where there is a lot more competition.

Games Workshop is the world leader in fantasy miniature characters that is underpinned by the Warhammer and Warhammer 40,000 brands. It also has the licences for The Lord of the Rings and The Hobbit tabletop battle games. It has a bank of intellectual property which allows it to develop a continuous stream of new products. When combined with its tooling and manufacturing there is a significant barrier to entry in this business.

The most important part of the business is its network of 462 shops in 23 countries. 360 of these are run by one person. The shops are where the company's brand and the promotion of its products is at its strongest as it does not advertise. The shops are where people can come and see the newest products and get involved with the many games on offer. They can also order from the entire catalogue of products using web terminals in store.

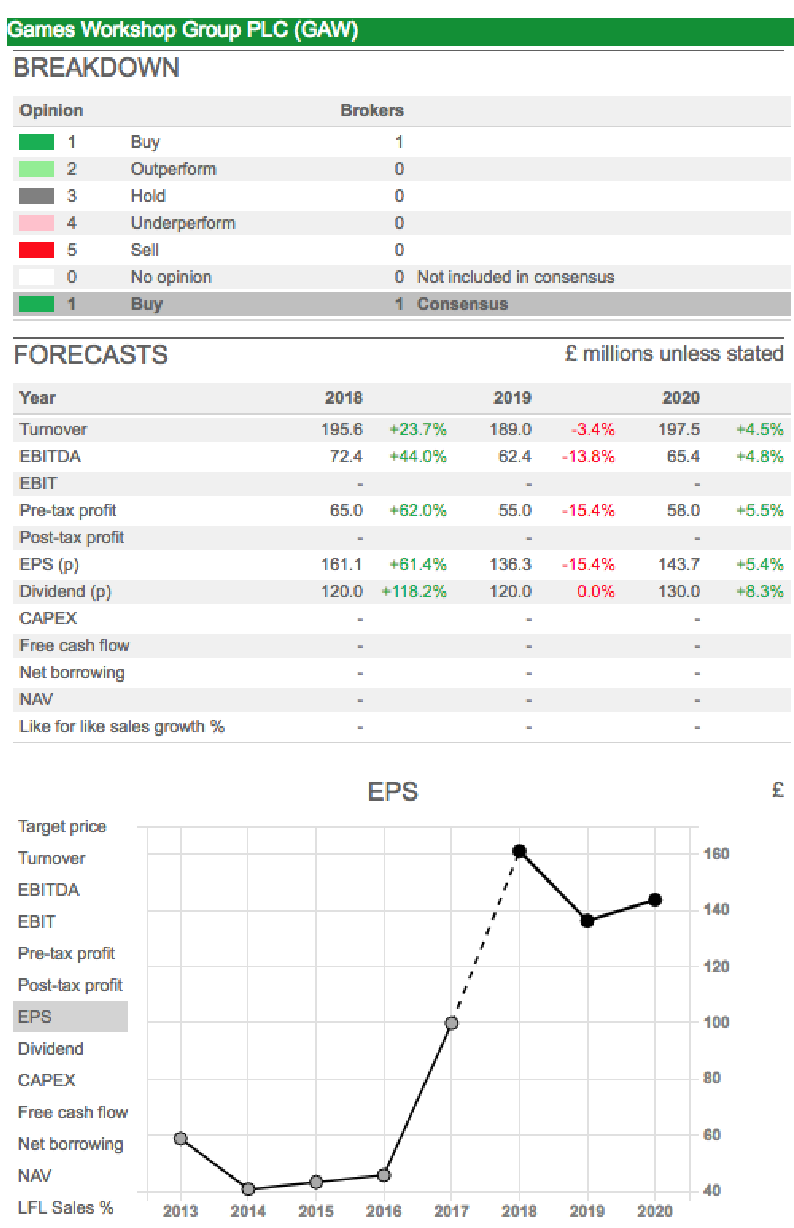
The company also seems to do a good job of promoting its products elsewhere with its White Dwarf magazine, Warhammer TV and the website warhammer-community.com as well as the company's own website. These are used to bring its characters to life and engage existing and new customers.



This is also a business with a high proportion of fixed overhead in the manufacturing and store network which gives it a lot of operational gearing. If it is producing and selling a lot of products then profits can increase rapidly - as is happening at the moment but the process can also work in reverse. A look at its historic profit margin performance shows how volatile it has been.

The company is in a sweet spot at the moment with successful launches of its Warhammer 40k Dark Imperium products and good momentum in its core Warhammer, Age of Sigmar, Forge World and Black Library ranges. It is looking to leverage this momentum by opening 25 new stores (net of closures) in 2017/18 and by signing up new trade accounts.

Things are going so well with this company at the moment that there has been a series of profit upgrades throughout the year. My guess is that more upgrades are very possible.



Games Workshop Group PLC (GAW)

BREAKDOWN

Opinion		Brokers	
1	Buy	1	
2	Outperform	0	
3	Hold	0	
4	Underperform	0	
5	Sell	0	
0	No opinion	0	Not included in consensus
1	**Buy**	**1**	**Consensus**

FORECASTS £ millions unless stated

Year	2018		2019		2020	
Turnover	195.6	+23.7%	189.0	-3.4%	197.5	+4.5%
EBITDA	72.4	+44.0%	62.4	-13.8%	65.4	+4.8%
EBIT	-		-		-	
Pre-tax profit	65.0	+62.0%	55.0	-15.4%	58.0	+5.5%
Post-tax profit	-		-		-	
EPS (p)	161.1	+61.4%	136.3	-15.4%	143.7	+5.4%
Dividend (p)	120.0	+118.2%	120.0	0.0%	130.0	+8.3%
CAPEX	-		-		-	
Free cash flow	-		-		-	
Net borrowing	-		-		-	
NAV	-		-		-	
Like for like sales growth %	-		-		-	

In a recent trading statement, the company said that during the first six months of the year sales were £109m and trading profits (EBIT) were around £38m. That is the same amount of profit made for the whole of 2016/17.

Forecasts are a bit thin on the ground for this company with only one broker contributing to consensus. Full year pre-tax profits are forecast to be £65m. Given that the company has no debt and assuming little in the way of interest income this implies second half profits of £27m.

I think this is too low given the current levels of trading momentum in the business and the benefits to profits that operational gearing will bring. I find it hard to believe at this moment in time that the company will make less money in the second half of the year but I could be wrong.

The company is committed to paying out cash dividends to shareholders and has declared 85p in three instalments so far this year. This compares with the 74p declared last year. This means that shareholders get a tangible return on their investment in the shares and benefit from the current impressive rates of growth with more cash in their pockets.

My only issue with this business is that I've no idea what kind of sustainable profits and margins it is capable of. This makes it difficult to value.

Profit margins are at record highs but that doesn't mean that they can't go higher. If my view is right that profit forecasts are too low and the company can make at least another £38m in the second half of the year then assuming a 20% tax rate would give post tax profits of £60.8m and EPS of around 188p. At a share price of 2286p, this would put the shares on a prospective PE of 12.2 times or 11.8 times adjusting for a conservative net cash estimate of £20m.

This is not a high valuation for most businesses but the lack of future visibility of earnings and their historic volatility - caused by high operational gearing - means that it suggests to me that this is not a business which should command a high multiple of earnings.

That said, management are working hard to promote the products and engage better with existing and potential customers, as well as increasing the business' geographic footprint across the world. If this can increase the customer base then

new releases stand a chance of being more successful. If so, then the long-term sustainable profits of this business have the potential to increase in my view.

Games Workshop is a unique business and one that I very much like the look of. I don't own any shares at the moment but am going to do some more research as I must admit to being quite tempted by them.

Safestyle UK (LSE:SFE)

If you asked me at any time over the last ten years if I wanted to own shares in a double glazing business I would have said "no". To me, they are selling a commoditized product with lots of competition in a cyclical industry. There's also the anecdotal evidence which suggests that millions of houses have already had it installed which would make me question - possibly wrongly - the long-term demand for the product.

Up until this year, Safestyle UK has done a good job of proving the cynics like me wrong. It had been doing very well by growing its sales and profits whilst making returns on capital of over 30%.

Yet the company's profits and share price have come crashing down. Before a profit warning in July, analysts expected pre-tax profits for 2017 of £20m. At the start of this week the figure was £16m until another profit warning was announced for 2017 and 2018:

"With sales in the short month of December not helped by severe weather disruption to the planned installation programme, ***it is clear that Q4 sales will now be below our already reduced expectations. At the same time, those sales have come at an increased cost of acquisition, due to higher lead generation expense in a competitive landscape and a higher proportion being made on extended finance terms, negatively impacting margins.*** *As a consequence, our 2017 full year outturn (namely underlying profit before tax, before exceptional restructuring costs and share based payment charges) is now expected to be below current market expectations,* **at a level of least GBP15 million."**

SafeStyle UK Ltd (SFE)

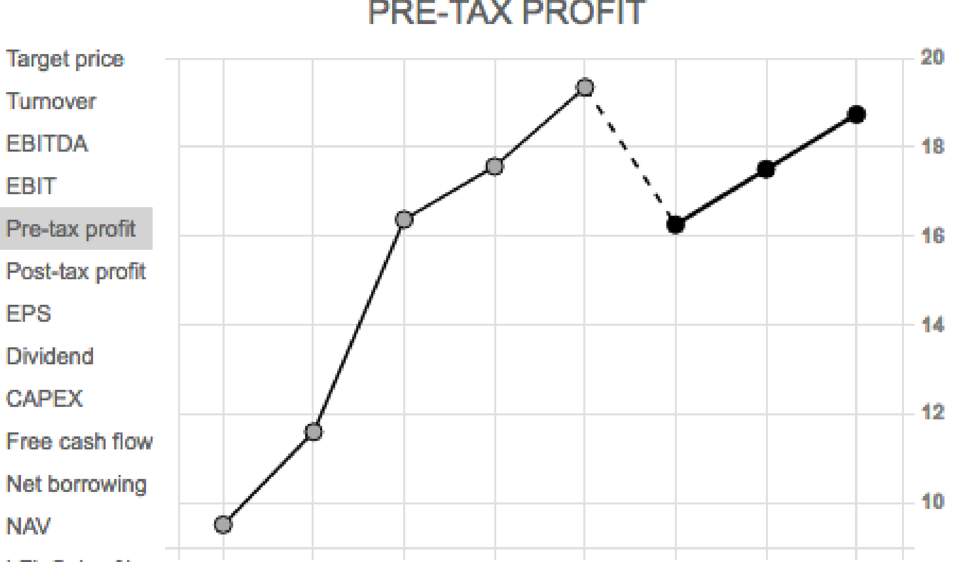
BREAKDOWN

	Opinion		Brokers	
	1	Buy	1	
	2	Outperform	0	
	3	Hold	1	
	4	Underperform	0	
	5	Sell	0	
	0	No opinion	1	Not included in consensus
	2	**Outperform**	**3**	**Consensus**

FORECASTS

£ millions unless stated

Year	2017		2018		2019	
Turnover	160.5	-1.6%	160.5	-0.0%	165.5	+3.1%
EBITDA	17.7	-13.5%	19.0	+7.7%	20.2	+6.2%
EBIT	16.2	-15.8%	17.4	+7.7%	18.6	+6.6%
Pre-tax profit	16.3	-16.0%	17.5	+7.7%	18.7	+7.1%
Post-tax profit	13.0	-16.5%	14.2	+9.2%	15.2	+7.0%
EPS (p)	15.7	-17.0%	17.0	+8.3%	18.2	+7.1%
Dividend (p)	11.3	+0.4%	11.4	+0.9%	11.7	+2.6%
CAPEX	5.4	-8.8%	1.6	-70.4%	1.6	0.0%
Free cash flow	9.0	-21.1%	14.3	+58.9%	15.2	+6.3%
Net borrowing	-12.4	-7.7%	-16.5	+33.1%	-21.5	+31.0%
NAV	38.1	-0.6%	41.2	+8.1%	44.8	+8.7%
Like for like sales growth %	-		-		-	



"Looking ahead, we expect market conditions to continue to be very challenging in 2018 and, although we aim to further consolidate our position of market leadership, the Board has lowered its expectations of the Group's performance in FY2018. The benefits of our cost saving and efficiency programme will fall mainly in 2018 and as such should help mitigate the impact on profitability of any further fall in market demand. ***We, therefore, expect only modest growth in earnings over 2017."***

It is particularly worrying that the company is talking about having to offer extended finance in order to win business in a very competitive market. The danger here is that this situation gets worse as rival companies scrap for the reduced amount of business up for grabs.

To me modest earnings growth over 2017 might be a little over optimistic. Judging by the 16% fall in the share price on the day of the trading statement it seems that the market is of a similar view.

The one potential ray of sunshine in a bleak outlook is that capex should come down after the company's recent investment projects have been completed. This should boost free cash flow and mean that the dividend is safe for now. However, no matter how tempting a prospective yield of 7% might seem, I think that more earnings downgrades are very likely with this company. If I am right then the shares could resemble a classic value trap.