Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

19th January 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7700.96	▼-0.798	▲2.18	▲6.26	7778.64	7099.15	12/1/18	31/1/17
FTSE 250	20665	▼-0.352	▲2.02	▲12.8	20932.6	18081.8	5/1/18	30/1/17
FTSE SmallCap	5998.4	▼-0.366	▲3.53	▲14.5	6038.69	5207.06	15/1/18	31/1/17
FTSE AIM 100	5457.76	▼-0.0987	▲4.46	▲30.9	5506.5	4158.67	5/1/18	23/1/17
FTSE All-Share	4227.86	▼-0.71	▲2.2	▲7.59	4268.89	3858.26	12/1/18	31/1/17
S&P 500	2796.83	▲1.06	▲3.97	▲23.1	2802.56	2263.69	17/1/18	19/1/17
Brent Oil Spot $	$69.405	▲0.398	▲9.45	▲27.9	$70.225	$44.785	15/1/18	21/6/17
Gold Spot $ per oz	$1330.78	▲0.598	▲5.49	▲10.6	$1349.10	$1188.45	7/9/17	26/1/17
GBP/USD - US Dollar per British Pound	1.3897	▲2.63	▲3.87	▲13.3	1.3897	1.21561	18/1/18	9/3/17
GBP/EUR - Euros per British Pound	1.13485	▲0.929	▼-0.0396	▼-1.62	1.1972	1.0795	18/4/17	29/8/17

Top Risers

No.	TIDM	Name	%chg 1w
1	GKN	GKN PLC	▲33.8
2	UBM	UBM PLC	▲23.7
3	STCK	Stock Spirits Group PLC	▲13.9
4	GEMD	Gem Diamonds Ltd	▲11.7
5	LAM	Lamprell PLC	▲11.7
6	GYM	The Gym Group PLC	▲11.6
7	RNO	Renold PLC	▲11.3
8	MRO	Melrose Industries PLC	▲9.63
9	RCDO	Ricardo PLC	▲9.44
10	PRV	Porvair PLC	▲8.4

Top Fallers

No.	TIDM	Name	%chg 1w
1	CAR	Carclo PLC	▼-35.2
2	CLLN	Carillion PLC	▼-28.9
3	MGP	Medica Group PLC	▼-20.8
4	PFG	Provident Financial PLC	▼-20.8
5	CWD	Countrywide PLC	▼-18.9
6	NCC	NCC Group PLC	▼-11.9
7	LUCE	Luceco PLC	▼-11.3
8	BRBY	Burberry Group PLC	▼-10.7
9	MOSB	Moss Bros Group PLC	▼-10.1
10	PMO	Premier Oil PLC	▼-9.28

The lessons from Carillion (LSE:CLLN)

Unless you were betting on the company's collapse then there is little to celebrate from the sad demise of Carillion that was announced this week - especially as thousands of jobs are on the line because of it.

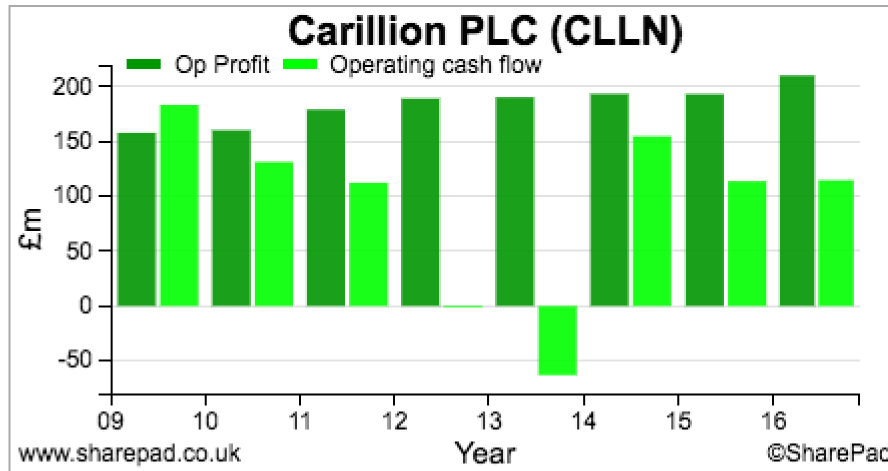
I held a very lukewarm view towards Carillion shares (see here and also my newsletter from 9th December 2016 which can be found by clicking the blue options button in the top right hand corner of the screen in SharePad) and did not like many of the things I saw within its financial statements.

As with many events in investing there can often be some simple but powerful lessons that investors can take away from a company that has failed. With any luck it can keep them away from problem businesses in the future.

Here are a few of my key takeaways from Carillion's demise:

1. High dividend yields are a sign of high risk and rarely represent a free lunch.
2. Businesses with lots of contracted revenues can be almost impossible for outside investors to understand. There can be limited visibility on costs and the flows of cash. Don't invest in a business that you can't understand.
3. Don't invest in businesses with very low profit margins. They can quickly become zero or negative margins.
4. Low profit margins combined with debts and pension fund deficits can be a toxic mix.

5. Never take a balance sheet debt figure as being the same as the actual level of debt throughout the year. Companies tend to present their balance sheets when debt levels are lowest and cash balances the highest.
6. Be very suspicious of companies where operating cash flows are significantly less than operating profits. The gap between the two was getting bigger at Carillion.



7. Be wary of companies with histories of big acquisitions. They can use the cost savings from them to mask problems of falling profits elsewhere in the business.

8. Be wary of directors who don't eat their own cooking. The actual number of shares owned outright by the executive directors was very small and below the guidelines of 100% of their salaries. The non executive directors either owned no shares or very small amounts.

Shareholding guidelines and total shareholdings of Directors

To provide alignment with shareholders' interests and to promote share ownership, each Executive Director is required to hold the net number of shares acquired through the LEAP and, with effect from 1 January 2014, the deferred bonus plan, until the value of their total shareholding is equal to their annual salary. The extent to which each Executive Director has met the shareholding guideline is shown in the table below.

The information in the table below has been audited.

					Unvested		
	Shareholding guidelines	Current shareholdings (% of salary)	Type	Owned outright	Subject to performance conditions	Not subject to performance conditions	Total as at 31 December 2016
Executive Directors							
Richard Howson	100 per cent of salary	137,487	Shares	137,487	N/A	N/A	137,487
		46%	LEAP award	N/A	828,345	48,028	876,373
			DBP shares	N/A	N/A	115,279	115,279
Zafar Khan	100 per cent of salary	1,368	Shares	1,368	N/A	N/A	1,368
		1%	LEAP award	N/A	99,900	N/A	99,900
			DBP shares	N/A	N/A	17,744	17,744
Richard Adam	100 per cent of salary	122,014	Shares	122,014	N/A	N/A	122,014
		63%	LEAP award	N/A	635,788	38,594	674,382
			DBP shares	N/A	N/A	93,472	93,472
Non-Executive Directors							
Philip Green	N/A	N/A	Shares	10,000	N/A	N/A	10,000
Keith Cochrane	N/A	N/A	Shares	Nil	N/A	N/A	Nil
Andrew Dougal	N/A	N/A	Shares	5,000	N/A	N/A	5,000
Alison Horner	N/A	N/A	Shares	3,000	N/A	N/A	3,000
Ceri Powell	N/A	N/A	Shares	Nil	N/A	N/A	Nil

Watkin Jones Group (AIM:WJG)

Watkin Jones makes money by building student accommodation blocks and selling them on to property investors. It takes a low risk approach to the business by typically forward selling a development before the building is completed. This is great from a cash flow and earnings visibility perspective and is an approach that has gone down well with investors since the company floated on the stock exchange in early 2016.

The company has been doing well and has just announced a 12.7% increase in trading profits for the year to September 2017 to £42.7m and an increase in the total dividend per share to 6.6p. The financial position of the business is strong with net cash balances of £41m.

Profit visibility for the next two to three years is excellent with a pipeline of 9,120 student beds over 23 sites with a development value of £762m. 3,415 beds have been forward sold for 2018 and 2,675 for 2019. In addition the company has or has contracts for five development sites for 1,500 build to rent units.

As far as profits for the next two to three years are concerned, I would say that most of the forecasts of City analysts are in the bag with very little in the way of earnings risks.

Watkin Jones PLC (WJG)

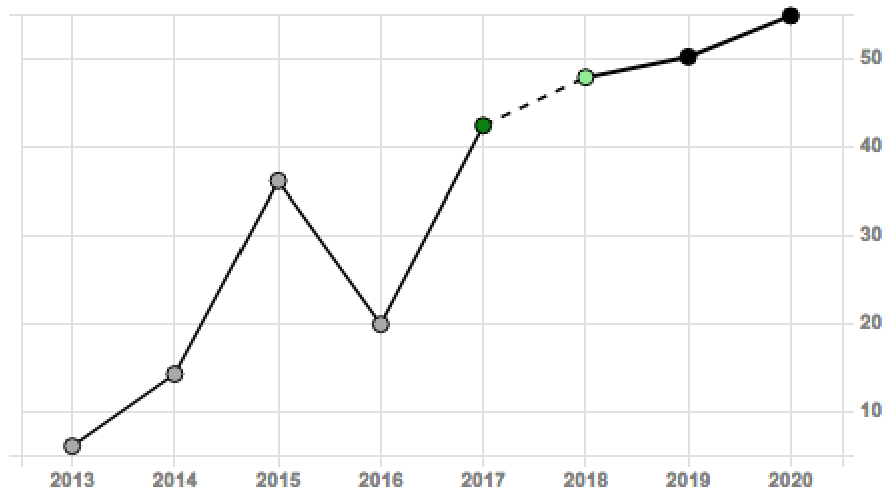
FORECASTS

£ millions unless stated

Year	2018		2019		2020	
Turnover	334.8	+10.9%	371.6	+11.0%	477.8	+28.6%
EBITDA	47.2	+6.6%	50.5	+6.9%	55.1	+9.2%
EBIT	45.6	+5.6%	49.4	+8.3%	55.0	+11.3%
Pre-tax profit	47.8	+12.9%	50.1	+4.9%	54.8	+9.3%
Post-tax profit	38.7	+11.1%	40.4	+4.4%	44.9	+11.1%
EPS (p)	15.2	+11.4%	15.8	+3.9%	17.6	+11.4%
Dividend (p)	7.3	+10.6%	8.0	+9.6%	8.6	+7.5%
CAPEX	0.4	+19.0%	0.5	+25.0%	-	
Free cash flow	31.9	+68.7%	25.4	-20.4%	-	
Net borrowing	-74.0	+80.5%	-87.1	+17.7%	-110.0	+26.3%
NAV	140.5	+11.3%	160.8	+14.4%	-	
Like for like sales growth %	-		-		-	

PRE-TAX PROFIT

£



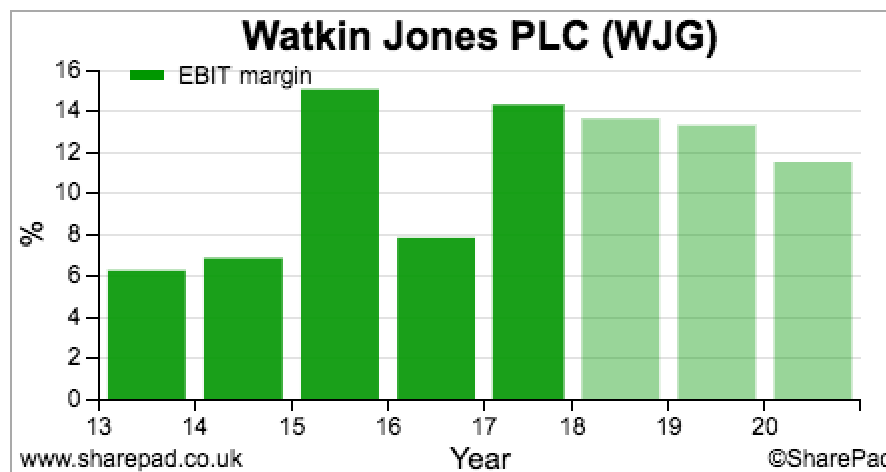
I can see why many investors find this appealing but there is a big difference between the quantity and quality of a company's earnings.

Watkin Jones makes most of its money from selling accommodation that it has built. There is very little in the way of recurring revenue as property management profits are tiny in comparison. To keep its profits the same or to grow them it has to keep finding and building out new accommodation sites.

I think it will find it challenging to keep increasing profits year after year. Lots of money is pouring into the purpose-built student accommodation sector and also the residential build to rent market. It is the latter where WJG is more upbeat about its future opportunities.

The key question is whether the company will be able to secure the necessary amount of work at attractive profit margins to keep its profits on an upwards trajectory in the years ahead. I certainly wouldn't be betting that it will as all forms of construction seem to have a degree of cyclicality and volatility to their sales and profits.

City analysts are predicting that profits will rise for the next three years but the profit margin is expected to come down.



My guess is that the reduction in margin could be due to a change in sales mix as build to rent margins may differ from student accommodation. I've also no idea if any margin from land sales is factored in. I also don't know if the trend in margin factors in any increase in competition for sites and projects but that is a risk in my view.

The other important issue with this business is how valuable is a company which doesn't have a lot of recurring income. Housebuilders and construction companies usually command low multiples of profits for this reason.

Yet Watkin Jones shares trade on a one year rolling forward PE of 13.5 times. That seems quite punchy to me given the nature of the business. One possible reality

check might be to compare WJG with Telford Homes (LSE:TEF) as it too is pursuing growth in the build to rent market in London.

This is an interesting exercise for investors in any company as it shows how comparing valuations using PE ratios can give confusing messages when one company (Telford) has debts and the other (WJG) doesn't.

TIDM	Name	Close	Market Cap. (intraday) (m)	PE roll 1	fc Norm Pre-tax	2y fc Norm Pre-tax	3y fc Norm Pre-tax	fc Net borrowing
TEF	Telford Homes PLC	431.5p	£323.6	8.0	44.0	52.0	54.0	186.3
WJG	Watkin Jones PLC	207p	£527.1	13.5	47.8	50.1	54.8	-74.0

WJG and Telford have very similar expected levels of pre-tax profits over the next three year. Yet, WJG's market capitalisation is just over £200m more than Telford's. Telford trades on a rolling PE of 8 against 13.5 for WJG. Surely Telford is much cheaper than WJG.

Well this is not actually true as the table below highlights.

Name	Close	Market Cap. (intraday) (m)	fc Net borrowing	Forecast EV	fc Norm EBIT	2y fc Norm EBIT	3y fc Norm EBIT
Telford Homes PLC	431.5p	£323.4	186.3	511.35	48.7	58.4	61.4
Watkin Jones PLC	207p	£527.8	-74.0	454.41	45.6	49.4	55.0

According to consensus forecasts, Telford's debts are set to increase sharply as it begins new developments. WJG's cash balances are expected to increase. Using SharePad's **Combine items** function I have created a column showing the forecast enterprise values for both companies using the current market capitalisation and adding to it the forecasts for net borrowings or net cash.

Name	Forecast EV	EBIT yield 1	EBIT yield 2	EBIT yield 3
Telford Homes	£511.35m	9.52%	11.42%	12.00%
Watkin Jones	£454.41m	10.03%	10.87%	12.32%

What we can see here is that Telford actually has a bigger enterprise value than WJG. But what can the investor expect back in trading profits by paying the current EVs for both businesses. You can work this out by working out the forecast EBIT yields by taking the forecast EBIT and dividing it by the forecast EV.

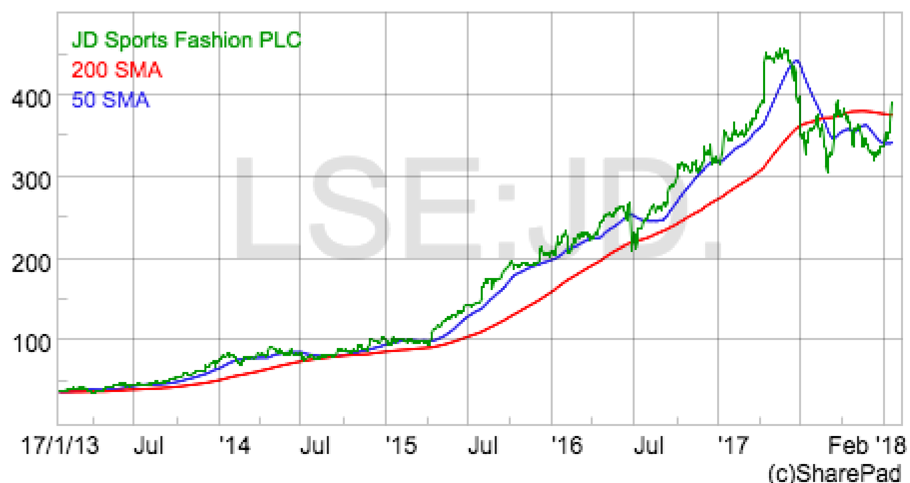
If these forecasts turn out to be accurate then there is little to choose between the two businesses in terms of the rate of return they will give investors.

If the profits were sustainable, I could argue that both businesses look to be attractively valued but my gut feeling is that they are not. Given the sell-off in the share price since last autumn it may be that many investors hold a similar view.

Watkin Jones is undoubtedly good at what it does but perhaps the easy money has been made from this share. The announcement that the chief executive is standing down - for personal reasons - after 15 years may also reinforce this view in the eyes of some investors.

JD Sports (LSE:JD.)

JD Sports has proven to have been one of the best retailers on the high street in recent years. In the three years 2014-16 it increased its like-for-like sales by more than 10% per year. Not many high street retailers have done that.



The company has undoubtedly benefited from the chaos at arch rival Sports Direct and taken market share from it in trainers and sports fashion but it is still growing sales from its existing stores despite the strong growth of the last few years.

With the core UK business performing well, the company is setting its sights on building a strong overseas business by opening up new stores in Europe and places such as Australia and Malaysia.

There is also scope to increase the profits from the chains of Go Outdoors and Blacks Leisure shops that the company has bought in recent years.

This week the company announced that same store sales in the UK had continued to increase at the 3% rate it was achieving during the first half of the year. Same store sales growth in Europe was growing at 7% during the first half but the company has not given a figure in the trading update which implies a little bit of a slowdown in growth.

The good news for shareholders is that profits for the year to February 2018 are going to be higher than expected. Profit before tax was expected to be at the upper end of a range of £270m to £295m and is now expected to be around £300m.

This week's trading statement is very reassuring. I have no doubt that there would have been some nervous investors who might have had some worries about the company's ability to keep sales growing in these challenging times for high street retailers. A small profit upgrade and a sense of relief sparked a sharp upwards movement in the share price.

JD Sports Fashion PLC (JD.)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	3,058.1	+28.6%	3,415.2	+11.7%	3,725.5	+9.1%
EBITDA	363.3	+19.8%	398.0	+9.5%	430.5	+8.2%
EBIT	294.0	+22.1%	324.3	+10.3%	357.4	+10.2%
Pre-tax profit	295.2	+20.4%	325.1	+10.1%	352.7	+8.5%
Post-tax profit	226.6	+22.0%	249.9	+10.3%	275.7	+10.3%
EPS (p)	23.1	+21.1%	25.5	+10.4%	28.2	+10.6%
Dividend (p)	1.6	+18.5%	1.7	+6.3%	1.8	+5.9%
CAPEX	160.0	+97.4%	160.0	0.0%	160.0	0.0%
Free cash flow	128.8	-35.0%	153.8	+19.4%	189.4	+23.2%
Net borrowing	-322.9	+51.2%	-460.8	+42.7%	-633.5	+37.5%
NAV	782.0	+41.6%	1,020.2	+30.5%	1,283.1	+25.8%

On the face of things it's very hard to be downbeat about this business. It is doing a good job in selling more goods to customers and growing profits for shareholders. The company has profit margins of nearly 10% and makes a return on capital (adjusted for rented shops) of around 20%. It has a large and growing pile of cash on its balance sheet as well.

All this is good, but looking further ahead I do have a few doubts as to whether JD Sports can keep on growing at a stellar rate. The laws of retail economics will surely mean that like-for-like sales growth will be quite modest given the strong growth in previous years.

However, I feel a more important challenge faces this business. Whilst the company does have a portfolio of its own brands its sales and profits are very dependent on selling the brands of big global sportswear giants such as Nike and Adidas. These companies want to sell more of their clothes and trainers direct to consumers. No doubt, companies such as Amazon want a bigger slice of the cake as well.

JD Sports is a big prominent sports and leisure retailer and is an important route to market for the likes of Nike and Adidas. But I think investors should be wary of this relationship changing. It might not happen overnight but I do think that this represents a real risk to the business.

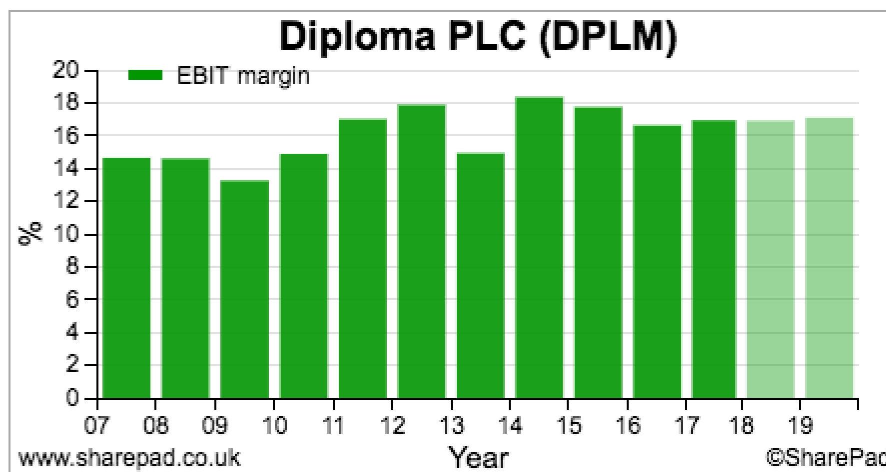
At 385p, the shares trade on a one year rolling PE of 15.3 times. If we take into account that the company could have 47p per share of net cash by February 2019 that multiple comes down to 13.3 times. This is not expensive by any means if profits can keep growing at a healthy clip. Concerns about the long-term prospects for the current business model might put some long-term investors off the shares.

Diploma (LSE:DPLM)

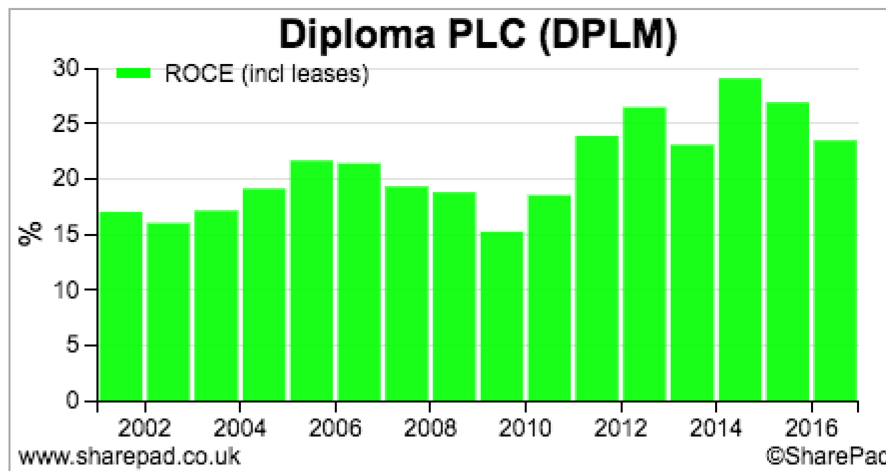
(Disclosure: I currently own shares in Diploma)

I think Diploma is a great example of a high quality business. It makes niche, problem solving products, the cost of which is a day to day operating expense for its customers. This gives Diploma a regular and consistent source of income rather than a lumpy one (if it sold capital equipment that was bought or replaced only from time to time).

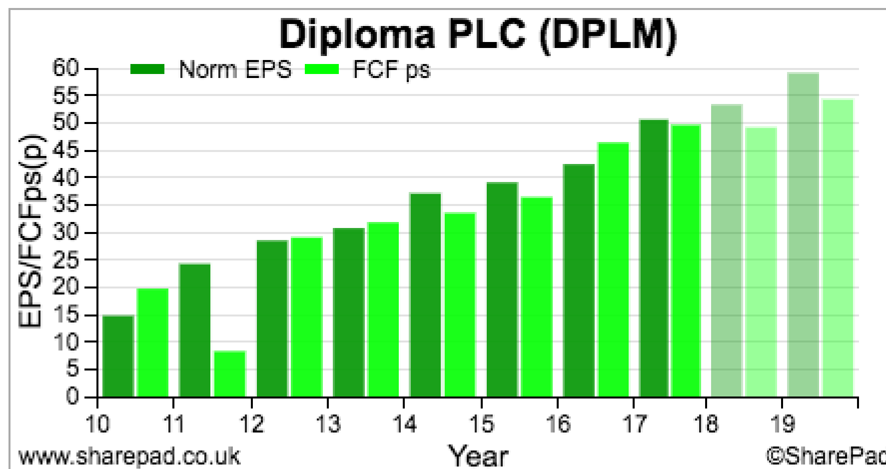
The business has great operating margins that have been very stable over time.



This translates into high returns on capital employed (ROCE).



And the company has been very good at turning its profits into free cash flow.



To top things off, Diploma has proven to be very adept at growing its profits. It has done this through a combination of organic growth from existing businesses and successfully buying and integrating new ones. Check out Richard Beddard's excellent article Buy and Build which goes into detail as to how Diploma has done this.

For those of you that are not familiar with Diploma and what it does, here is a brief description of its three main businesses:

- **Life Sciences** - sells medical devices to the Healthcare sector; 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, Energy and Food & Beverages.

This week's first quarter trading update suggests that the company is ticking along nicely. Given that the company had a significant benefit from the falling value of the pound last year - which has now disappeared - revenue growth of 14% at constant exchange rates (6% from previous acquisitions and 8% underlying growth) is a good result. The strengthening pound compared with last year cut actual sales growth to 10%.

The Life Sciences division has delivered 10% underlying sales growth and has extra sales and profits from the purchase of an Australian diagnostics business called Abacus which was bought last year.

Seals - the biggest profit generator for the company - has seen 6% sales growth with strong growth in North America offset by weaker trading in Russia and Australia.

The Controls business has also kept up the strong sales momentum from last year with sales up 7% on the back of strong European markets.

Profit margins are nudging up which is good news and cash generation remains good. Net cash of £21.9m at the end of December is down slightly from the September figure of £22.5m. I don't see this as a bad issue as working capital inflows move around a lot during the year.

The company has also said that is expects its tax rate to fall from 26.5% to 24% this year as a result of the recently announced US corporation tax rate cuts. This should give a small boost to post tax profits and EPS.

Diploma PLC (DPLM)

FORECASTS £ millions unless stated

Year	2018		2019		2020	
Turnover	479.7	+6.1%	500.3	+4.3%	523.1	+4.6%
EBITDA	88.2	+8.6%	92.8	+5.2%	97.7	+5.3%
EBIT	81.1	+6.0%	85.5	+5.4%	92.8	+8.5%
Pre-tax profit	83.1	+8.6%	87.8	+5.6%	92.8	+5.7%
Post-tax profit	60.7	+6.1%	64.3	+5.9%	68.2	+6.1%
EPS (p)	53.3	+5.4%	59.1	+10.9%	59.3	+0.3%
Dividend (p)	26.7	+16.1%	28.6	+7.1%	28.7	+0.3%
CAPEX	5.5	+65.5%	4.8	-12.1%	4.9	+2.5%
Free cash flow	55.6	-0.9%	61.4	+10.4%	68.8	+12.0%
Net borrowing	-48.8	+118.9%	-80.3	+64.5%	-114.0	+42.0%
NAV	291.8	+11.4%	319.0	+9.3%	347.7	+9.0%

The “in line” comment in the company’s trading update means that analysts are unlikely to change their forecasts at the moment.

At just over £12 the shares are not cheap on a one year rolling PE of 21.8 times but I own these shares as I believe they are a reasonable long term investment. The fact that the chief executive is leaving and a new one has not been announced yet does not bother me as the strategy of the business is well known, works and seems entrenched in the culture of the company.

In some ways this company has similarities to Halma (LSE:HLMA) which is another one of my holdings. Halma has been very successful at buying and building up high quality niche businesses with high profit margins and high returns on capital over the years. It has just entered the FTSE 100 index. I’m not suggesting that Diploma will follow the same path but its consistent results suggests it has a portfolio of businesses and skills that should serve long-term investors well.