

Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users



16 February 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7234.81	▲0.894	▼-6.88	▼-0.926	7778.64	7092.43	12/1/18	9/2/18
FTSE 250	19574.8	▲1.28	▼-6.04	▲3.97	20932.6	18588.6	5/1/18	24/2/17
FTSE SmallCap	5695.84	▲0.842	▼-5.68	▲6.29	6038.69	5288.34	15/1/18	28/2/17
FTSE AIM 100	5317.54	▲1.08	▼-2.49	▲22.4	5550.39	4343.1	29/1/18	15/2/17
FTSE All-Share	3978.9	▲0.955	▼-6.7	▲0.117	4268.89	3902.85	12/1/18	9/2/18
S&P 500	2698.63	▲4.56	▼-3.14	▲14.9	2872.87	2328.95	26/1/18	13/4/17
Brent Oil Spot \$	\$64.375	▲0.187	▼-8.33	▲15.6	\$70.72	\$44.785	24/1/18	21/6/17
Gold Spot \$ per oz	\$1353.90	▲2.4	▲0.915	▲9.79	\$1356.22	\$1200.05	24/1/18	9/3/17
GBP/USD - US Dollar per British Pound	1.40557	▲0.86	▲1.9	▲12.7	1.42661	1.21561	1/2/18	9/3/17
GBP/EUR - Euros per British Pound	1.1261	▼-0.924	▲0.133	▼-4.23	1.1972	1.0795	18/4/17	29/8/17

Top FTSE All-Share rises

No.	TIDM	Name	%chg 1w
1	HRG	Hogg Robinson Group PLC	▲50
2	NANO	Nanoco Group PLC	▲30.4
3	PDG	Pendragon PLC	▲23.2
4	OXB	Oxford BioMedica PLC	▲17.6
5	EVR	Evrax PLC	▲13.9
6	HOC	Hochschild Mining PLC	▲13.8
7	FRES	Fresnillo PLC	▲12.9
8	FDSA	Fidessa Group PLC	▲12.6
9	KAZ	KAZ Minerals PLC	▲11.4
10	PDL	Petra Diamonds Ltd	▲11.3

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	UPGS	UP Global Sourcing Holdings ...	▼-36.7
2	GFRD	Galliford Try PLC	▼-13.8
3	GEMD	Gem Diamonds Ltd	▼-13.1
4	ENQ	EnQuest PLC	▼-9.89
5	LRE	Lancashire Holdings Ltd	▼-9.5
6	PMO	Premier Oil PLC	▼-9.36
7	ITE	ITE Group PLC	▼-9.22
8	ARW	Arrow Global Group PLC	▼-8.77
9	EIG	EI Group PLC	▼-8.75
10	MTC	Mothercare PLC	▼-8.3

Hargreaves Lansdown (LSE:HL.)

Share price: 1670p Mkt Cap: £7.7bn EMS: 1500 No. analysts: 16

If you were to ask me to name a company that closely resembled the description of a money making machine then two companies would immediately spring to mind.



One is the property website Rightmove (LSE:RMV) and the other is Hargreaves Lansdown (HL.).

HL is really a very simple business. It gives private investors a safe place to manage their investments - such as their SIPP's or ISAs - in return for a fee and it gives fund managers a platform to sell their funds to private investors. In return, customers pay a platform fee to HL. HL also runs its own investment funds and receives fee income from them.

The company also makes money from giving financial advice, organising customers' pensions when they retire and from commissions on the buying and selling of shares by customers.

To me, one of the big reasons for HL's success has been the way it has marketed its services and engaged with its customers. It has been brilliant at holding its customers' hands and providing them with a high quality service in the forms of investor tools and education. This makes for happy customers who are likely to stay with the company. Customer retention rates are excellent at 94.5%.

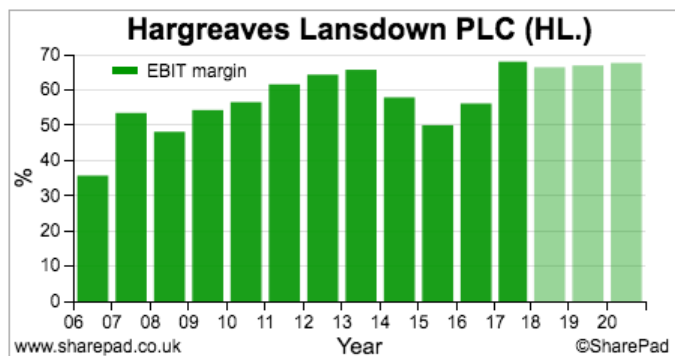
More than a million customers are using HL’s investment platform to manage their own savings. This number is probably going to increase given that Barclays Stockbrokers seems to be imploding just now.

If you have lots of fee paying customers when a large proportion of your costs are fixed you can make a lot of money. The money management business is all about scale. Once you have got enough customers to cover your costs, each additional paying customer becomes very profitable as most of the fees they pay ends up as profit.

This is what has happened at HL and it has turned into one of the most profitable businesses on the UK stock market.

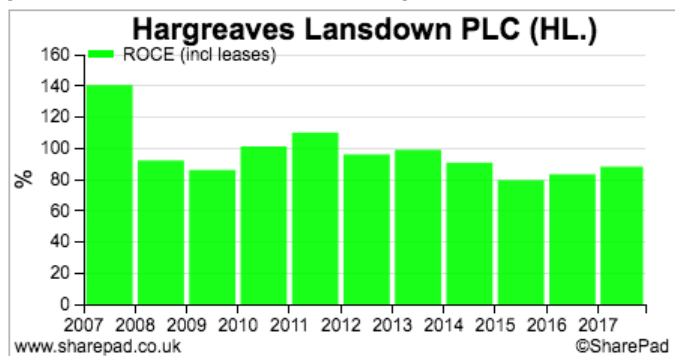
Its profit margins are phenomenally high.

Its return on capital employed (ROCE) is what most businesses dream of.



These levels of profitability have generated a lot of jealousy and criticism of the business. Terry Smith at one of his investor meetings called the company a “distributor” and alluded to the fact that other distributors don’t make anything near the kind of profit margins that HL does.

I think Terry Smith is essentially right about his description of most of HL’s business. One simple question to ask is why haven’t these high profit margins been competed away?



Apart from its excellent customer service mentioned above, I think a lot of the answer rests with the way that investors are charged for holding funds (OEICS not investment trusts) in their accounts. It may also explain why HL spends a lot of its time promoting funds to its customers. Platform funds are very lucrative for investment platforms such as HL.

Let me show you how.

Here is the current fee schedule for HL taken from its website.

Now let's look at the differences in the money paid by two different customers with a SIPP. One invests entirely in shares, ETFs and investment trusts. The other invests entirely in funds.

Shares, investment trusts, ETFs, gilts & bonds	
Fund & Share Account	No charge
ISA	0.45% a year (capped at £45 a year)
SIPP	0.45% a year (capped at £200 a year)
<hr/>	
Funds	
This charge applies to each Vantage account separately. It is tiered within bands: 0.45% per annum on the first £250,000 of funds; 0.25% for funds between £250,000 and £1m; 0.1% for funds between £1m and £2m, and no charge on the value of funds over £2m.	
Amount	Charge
£0 - £250,000	0.45%
£250,000 to £1m	0.25%
£1m to £2m	0.10%
Over £2m	0.00%
<hr/>	
Cash	No charge

I want to make it very clear that this applies to all investment platforms that charge platform fees not just HL. The tiering of charges will be slightly different across the market.

Fees on the shares investor are 0.45% on the value of their account but this is capped at £200 per year. This means that once their account's value is more than £44,444 they do not pay more than £200 per year in fees.

This is not the case for the SIPP investor who puts all of their money in funds. As the size of their SIPP gets bigger they pay more to HL. Someone with £1 million invested in funds will pay annual platform fees of £3,000 compared with £200 by someone with £1 million in shares.

Fees paid by HL SIPP customers

It's not difficult to see how this is not a particularly good deal for customers. It's the main reason why I don't own funds at all.

Amount invested	Funds	Shares
£44,444	£200	£200
£100,000	£450	£200
£250,000	£1,125	£200
£500,000	£1,750	£200
£1m	£3,000	£200
£2m	£4,000	£200

I may be missing something but I don't see why platform providers should receive more money just because the value of an investment fund managed

by a third party fund manager has increased. It also may explain why platform providers such as HL make more money when the stock market in general rises.

I'm sure the argument from platform providers is that there are higher administration costs to look after funds. Maybe this is the case but I'd be astonished if the cost difference between fund administration and shares administration was as big as implied in the differences customers pay.

That said, there is no reason why platform providers can't compete on platform fees and there is evidence that some do. AJ Bell's fund charges are significantly cheaper than HL's.

Amount invested in funds	HL platform fee	AJ Bell platform fee
£0-£250,000	0.45%	0.25%
£250,000 - £1m	0.25%	0.1%
£1m - £2m	0.1%	0.05%

Source: Company websites

If an investor switched from a £1m fund portfolio with HL to AJ Bell they would pay £1375 per year. This is less than half but still looks a lot of money to a tightwad like me.

Yet HL is continuing to retain almost all of its customers and gain new ones. This could highlight a large amount of inertia from its customers or be a sign that HL is very good at looking after them.

At the moment it is difficult to come to any other conclusion than HL is doing a very good job at making the most of a very attractive business model and charging structure.

This was highlighted last week when the company released a very good set of half

	6 months ended 31 December 2017			6 months ended 31 December 2016			Year ended 30 June 2017		
	Net revenue GBPm	Average AUA GBPbn	Net revenue margin bps	Net revenue GBPm	Average AUA GBPbn	Net revenue margin bps	Net revenue GBPm	Average AUA GBPbn	Net revenue margin bps
Funds(1)	97.8	47.4(6)	41	80.5	38.4(6)	42	169.2	40.9(6)	41
Shares(2)	42.9	27.3	31	36.2	21.9	33	76.3	23.3	33
Cash(3)	18.2	8.4	43	18.6	7.3	51	36.6	7.5	49
HL Funds(4)	33.3	9.0(6)	74	26.3	7.0(6)	75	56.5	7.7(6)	73
Other(5)	23.8	-	-	23.2	-	-	47.0	-	-
Double-count(6)	-	(9.0)(6)	-	-	(7.0)(6)	-	-	(7.7)(6)	-
Total	216.0	83.1(6)	-	184.8	67.6(6)	-	385.6	71.7(6)	-

year results.

Funds remain the biggest part of HL's customer assets under management at 57% and are its biggest source of net revenue - they grew by over 20% and were helped by buoyant stock markets. The net margin on funds of 0.41% barely budged from a year ago.

As you can see, margins are holding up well with shares at the upper end of its expected range of 0.27%-0.33%.

There was no evidence of competition as slight changes in margin in funds reflect the tiered pricing structure which meant that as customers' funds increased in value they moved into a lower fee tier and brought the average margin down slightly.

This solid performance fed through to an 11.9% increase in pre-tax profits. This was less than the increase in sales of 16.9% mainly due to a big increase in staff costs as HL continues to invest in customer service.

HL looks set to deliver another year of decent growth as long as the markets hold up.

Hargreaves Lansdown PLC (HL.)						
FORECASTS						
£ millions unless stated						
Year	2018		2019		2020	
Turnover	442.8	+14.8%	499.6	+12.8%	561.6	+12.4%
EBITDA	299.9	+11.7%	344.2	+14.8%	391.3	+13.7%
EBIT	294.1	+12.1%	334.4	+13.7%	379.9	+13.6%
Pre-tax profit	295.4	+10.5%	337.0	+14.1%	383.2	+13.7%
Post-tax profit	238.2	+11.7%	272.0	+14.2%	309.1	+13.7%
EPS (p)	50.2	+11.7%	57.4	+14.3%	65.4	+13.9%
Dividend (p)	41.2	+42.1%	46.4	+12.6%	52.8	+13.8%
CAPEX	8.1	-38.5%	6.2	-23.4%	6.3	+1.6%
Free cash flow	236.4	+10.5%	267.7	+13.2%	307.5	+14.9%
Net borrowing	-269.0	+5.1%	-283.9	+5.5%	-339.4	+19.6%

The company has many of the hallmarks of an outstanding business but at a valuation of over 30 times one year forecast rolling EPS you are having to pay up for it.

Usually I'd love to own shares in a company like this but I just don't feel comfortable with its charging model on funds. Lots of people seem to be happy paying it but I wouldn't be. HL is also a business that is exposed to a downturn in equity markets through this structure.

AJ Mucklow (LSE:MKLW)

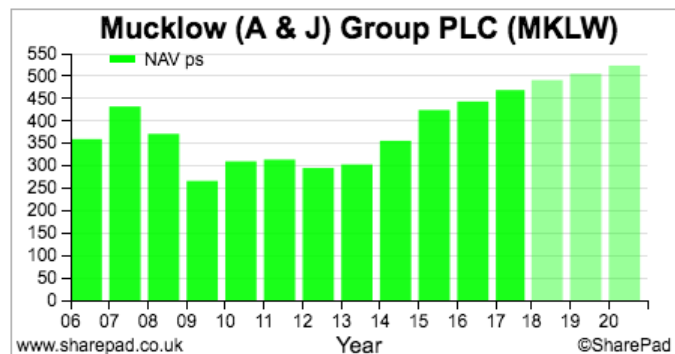
Share price: 504p Mkt Cap: £320m EMS: 750 No. analysts: 2



Mucklow has been a very conservatively managed property company for many years. It specialises in renting out industrial properties such as warehouses in the West Midlands.

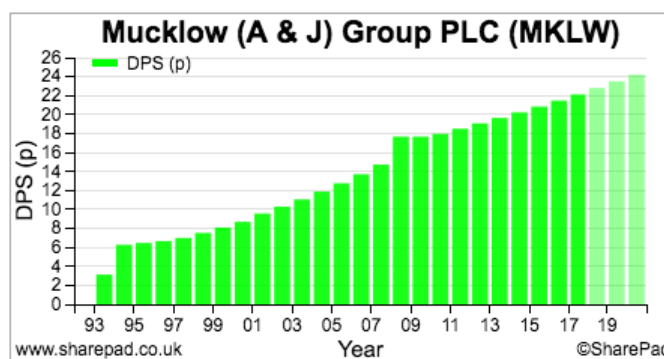
The company is a REIT and has chugged along nicely with a good track record of increasing its net asset value and paying an increasing dividend to shareholders - of which the Mucklow family remains the biggest with nearly 20% of the shares outstanding.

Since the trough seen at the time of the financial crisis in 2009, the company has preserved or grown its NAV per share. The rate of growth since 2013 has been good as lower yields have pushed up the value of its properties. (Note: property valuations are very similar to bonds in that they rise when interest rates fall).



As you can see from the chart above, City analysts are expecting NAV per share to keep on nudging up over the next three years.

This week's half year results made for reassuring reading. There was a tiny increase in underlying pre-tax profits which led to a 3% increase in the interim dividend. Gearing is also low with net debt to shareholders' funds coming down from 26% to 23%.



The only initial concern was an increase in the vacancy rate of the group's properties from 4.2% to 7.5%. Had the company not explained this, it would have been worrying. The good news is that the vacancy rate is due to come down in the second half as over half the group's vacant properties are currently under offer.

More good news is likely to come from the sale of two properties later on this year which should both be concluded at values in excess of their NAVs.

Mucklow (A & J) Group PLC (MKLW)

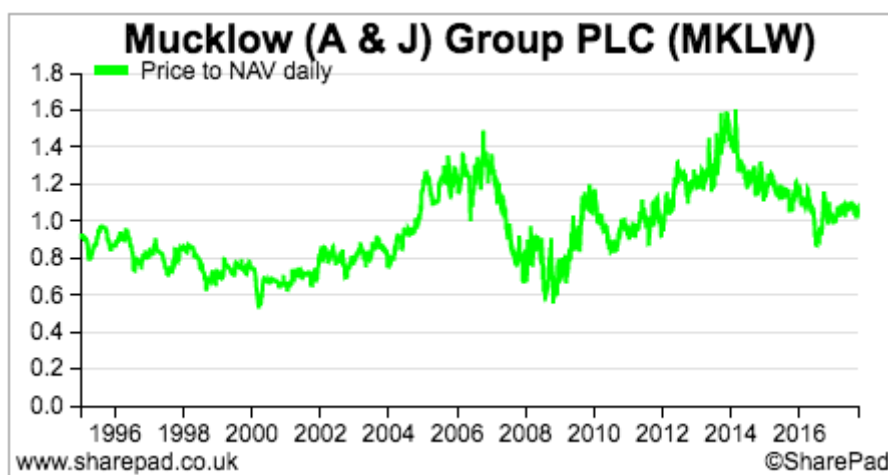
FORECASTS

£ millions unless stated

Year	2018		2019		2020	
Turnover	24.9	+0.8%	25.5	+2.4%	-	-
EBITDA	19.5	-8.9%	20.0	+2.6%	-	-
EBIT	19.4	-9.2%	19.8	+2.3%	19.8	0.0%
Pre-tax profit	16.1	-3.6%	16.6	+2.8%	16.7	+0.9%
Post-tax profit	30.4	+82.0%	23.2	-23.7%	23.4	+0.9%
EPS (p)	25.5	-2.9%	26.2	+2.7%	26.4	+0.8%
Dividend (p)	22.8	+3.1%	23.5	+3.1%	24.2	+3.0%
CAPEX	2.0	-82.5%	2.0	0.0%	2.0	0.0%
Free cash flow	16.2	+184.2%	16.7	+3.1%	-	-
Net borrowing	72.2	-7.2%	71.1	-1.5%	78.8	+10.8%
NAV	310.8	+4.8%	319.8	+2.9%	331.3	+3.6%

If you are on the lookout for a steady income producing share that you'd probably not worry about too much then Mucklow might be worth a little bit of your research time.

At 495p the shares offer a dividend yield of 4.6% with inflation matching dividend growth of around 3%. They are also now trading close to their NAV of 504p per share which makes for a more attractive entry point than has been on offer for a while.



You are unlikely to get rich owning this share but conservative investors might find a place for it in their portfolios.

Galliford Try (LSE:GFRD)

Share price: 839p Mkt Cap: £695m EMS: 1500 No. analysts: 6



At first glance, half year results from housebuilder and construction company Galliford Try look pretty decent. Sales were up by 14%, adjusted pre-tax profits up by 29% and EPS up by 31%.

Then comes the bombshell of a 13% cut in the dividend payment.

Like most housebuilders, Galliford Try is doing well. It is selling more houses and making more profit from them as evidenced by rising profit margins. It is the construction business which is the source of the dividend cut.

Many investors won't touch construction business as they don't know what's going on with them. The profit margins are wafer thin which tends to mean that you are only one big mistake away from serious trouble. Carillion's insolvency is a classic example of this.

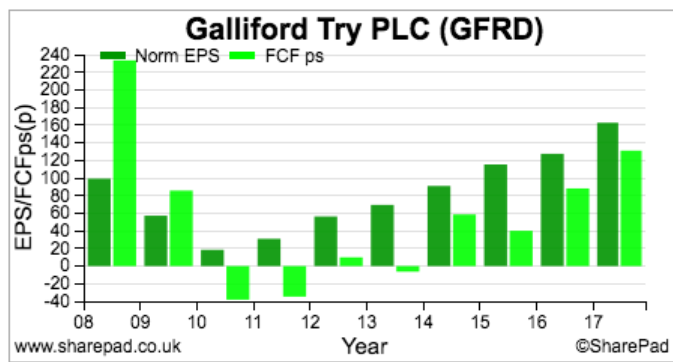
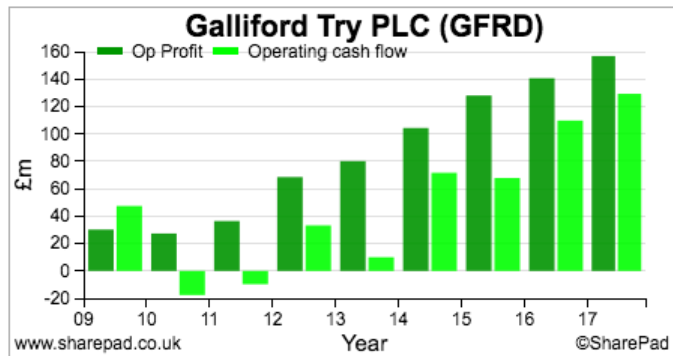
Galliford's construction business also hammers home this point. In the first half of the year it generated £823.6m of revenue but only made £7.2m of trading profit at a margin of 0.9%. You can be forgiven for thinking "what's the point in running a business like this?". It seems to be a case of a lot of work for very little in return with a lot of risk tagged on.

The business is taking a hit from its joint venture with Carillion on the Aberdeen Western Peripheral Route project - the Aberdeen bypass to you and me. It is going

to have to put more money in and has taken a one off hit of £25m. However, the need for more cash for this project has meant that the company is raising £150m of fresh equity funds and cutting its dividend so that it is covered twice by underlying profits going forward.

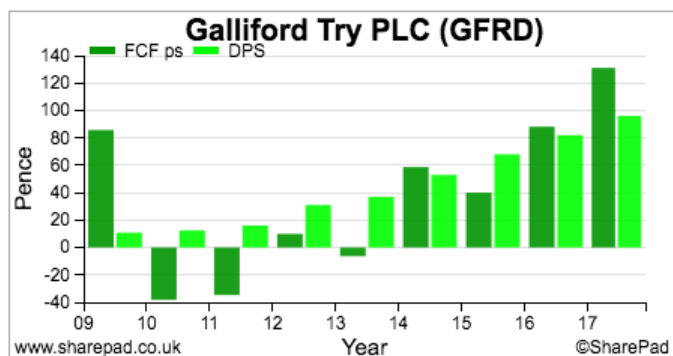
It seems as if the collapse of Carillion may be being used as a convenient excuse here. The Aberdeen bypass is apparently a very complicated road project and has been plagued with problems for some time. Given that £150m of fresh cash is being raised it seems that there is also a case of significant cost overrun at work here.

I've not looked at this company before but the dividend cut is not really that surprising. As with Carillion, there are warning signs that this is a business that is not very good at converting its profits into cash flow.



Operating profits haven't been fully converted into operating cash flow since 2009. This was presumably when the recession meant a scaling back of the construction and housing business which led to some working capital inflows.

Construction companies have cash flowing in and out of the business all of the time. Building companies also buy land which is treated as stock. This reduces operating cash flow and is not usually a sign of something sinister going on.



These characteristics mean that looking at free cash flow conversion can give you a better insight to the health of the company.

Despite a booming housing market, Galliford Try's free cash flow has lagged its EPS for many years. As with operating cash flow, free cash flow only exceeds profits in a downturn it would seem. The problem is that profits and cash flows tend to fall in absolute amounts at the same time.

Free cash flow dividend cover has been patchy but has been alright for the last couple of years.

However, both housebuilding and construction are highly cyclical businesses. Given that both are probably nearer the top than the bottom of the cycle and the extra costs mentioned above then a reduction in dividend payments is not too difficult to understand.

After a 19% fall in the share price on Wednesday, I'm sure that some investors will be eyeing the company as a potential bargain purchase.

Name	Close	Market Cap. (m)	PE roll 1	fc Yield	Price to NAV	EBIT margin	Lease-adj ROCE (7x, 7%)
Galliford Try PLC	800p	£663.1	4.4	11.5	1.2	5.9	10.8

It might well be and I wouldn't be surprised to see the shares bounce. That said, construction businesses and housebuilders do warrant a very low earnings multiple due to their cyclical and boom bust nature. The recent experience of Carillion and the cost problems in Aberdeen will also unnerve investors that there may be more skeletons in the cupboard.

Current forecasts are for reasonable profits growth but have not yet been adjusted for the £150m of fresh equity being raised.

Galliford Try PLC (GFRD)						
FORECASTS						
£ millions unless stated						
Year	2018		2019		2020	
Turnover	2,822.2	+6.0%	2,935.0	+4.0%	3,013.8	+2.7%
EBITDA	187.4	+14.7%	206.6	+10.3%	223.4	+8.1%
EBIT	181.5	+15.8%	200.4	+10.4%	217.7	+8.6%
Pre-tax profit	172.1	+18.8%	189.8	+10.3%	205.9	+8.5%
Post-tax profit	139.9	+3.7%	154.3	+10.3%	166.2	+7.7%
EPS (p)	169.1	+3.9%	186.8	+10.5%	201.7	+8.0%
Dividend (p)	92.2	-4.0%	97.3	+5.5%	104.1	+7.0%
CAPEX	13.7	+168.6%	13.7	0.0%	13.7	0.0%
Free cash flow	-		-		-	
Net borrowing	301.5		313.4	+4.0%	175.6	-44.0%
NAV	1,140.1	+98.1%	1,209.9	+6.1%	1,288.8	+6.5%

Water Companies

The shares of water companies have been taking a real hammering in recent weeks and months. The three quoted companies have seen their share prices fall by nearly a third over the last year.

TIDM	Name	Price	%chg 1y	fc Yield	2y fc Yield	3y fc Yield
PNN	Pennon Group PLC	607.8p	▼-28	6.2	6.6	7.1
SVT	Severn Trent PLC	£16.85	▼-26.7	5.0	5.4	5.8
UU.	United Utilities Group PLC	655p	▼-30.8	5.8	6.1	6.4

The sector is facing up to two big worries at the moment. One is the threat of re-nationalisation under a Labour government. The other is a threat from an upcoming regulatory review of the prices they charge their customers. The first threat is overstated in my opinion. The second one is not.

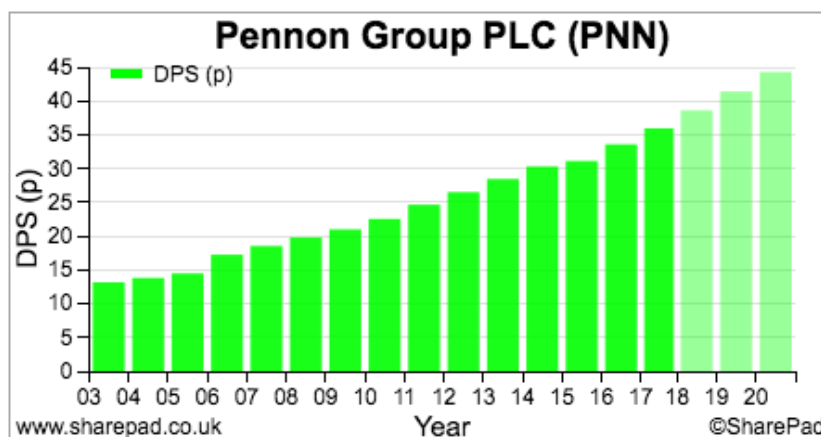
The next general election is not due until 2022. However, the current government is in a weak position and so it is entirely possible that an election happens before then. Even if a Labour government is elected, I'm not sure that would represent terrible news for water company shareholders.

I might be wrong but I cannot foresee a situation where the government will be allowed to re-nationalise these companies for less than their fair market value. The companies' lawyers would make it very difficult for this to happen.

The threat of a cut to prices at the next regulatory review in 2020 is very real in my view. Water companies have benefited from cheap borrowing costs and have been able to finance themselves for less than the regulator assumed when it last set prices in 2015. I think there's a good chance that a good chunk of those gains will be passed back to customers in the form of lower prices and profits.

If this comes to pass, then dividend cuts are a real possibility. Water companies tend to pay out all of their real profits - ones that reflect the current cost of replacing assets - in dividends. If those profits fall then dividends may follow suit.

Severn Trent and United Utilities have cut their dividends in the past, but Pennon has proven to be more reliable with consistently good levels of dividend growth.



Pennon's South West Water business is seen as a good operator and has been performing well. The company also has a waste business which provides an extra source of profits to pay dividends.

However, judging by the forecast dividend yields, it would seem that the market is more worried about Pennon's dividend than its peers. This is because higher yields are often seen as a sign of a higher likelihood of a dividend cut.

The threat of a Labour government will deter possible takeovers in this sector but contrarian investors might want to take a closer look at this sector. It could be that a lot of bad news is already priced into the shares.

One way in which professional investors look at how cheap or expensive water companies may be is to compare their enterprise values (market cap plus net debt) with their regulatory asset values (RAVs) which is the regulator's estimate of a water company's EV.

Company	EV (£bn)	Est. RAV (£bn)	Premium
Pennon	5.9	3.5	69%
Severn Trent	9.9	8.7	14%
United Utilities	11.7	11.0	6%

Estimated RAV taken from OFWAT website.

Water companies have been taken over at 40% premiums to their RAVs in the past but tend to be valued closer to RAV as regulatory reviews approach as investors worry about the prospect of price cuts and lower profits.

Generally speaking, the market value (EV) of a water company should only be more than its RAV if it can consistently make more money than the regulator thinks it will when it sets prices.

Pennon has a sizeable waste management business called Viridor that would probably be valued at more than £1bn. If this is deducted from the current EV then the water business is still valued at a 40% premium to its RAV. Severn Trent and United Utilities look better value on this measure.

If you want to spend more time understanding water companies and how to value them, check my article about [how to analyse and value water companies](#).