Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

16 March 2018

Market Overview

No.	Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
1	FTSE 100	7139.76	▼-0.881	▼-1.31	▼-3.11	7778.64	7069.9	12/1/18	2/3/18
2	FTSE 250	19828.4	▼-0.699	▲1.3	▲4.56	20932.6	18832.9	5/1/18	22/3/17
3	FTSE SmallCap	5755.88	▼-0.042	▲1.05	▲7.02	6038.69	5355.72	15/1/18	27/3/17
4	FTSE AIM 100	5501.67	▲1.94	▲3.46	▲22.9	5550.39	4447.2	29/1/18	22/3/17
5	FTSE All-Share	3947.16	▼-0.819	▼-0.798	▼-1.53	4268.89	3899.7	12/1/18	2/3/18
6	S&P 500	2753.61	▲0.535	▲0.821	▲15.4	2872.87	2328.95	26/1/18	13/4/17
7	Brent Oil Spot $	$65.0655	▲1.86	▲0.885	▲25.1	$70.72	$44.785	24/1/18	21/6/17
8	Gold Spot $ per oz	$1316.28	▼-0.362	▼-2.8	▲7.83	$1356.22	$1210.35	24/1/18	7/7/17
9	GBP/USD - US Dollar per British Pound	1.3935	▲0.95	▼-1.2	▲13.4	1.42661	1.22835	1/2/18	15/3/17
10	GBP/EUR - Euros per British Pound	1.1317	▲0.892	▲0.319	▼-1.08	1.1972	1.0795	18/4/17	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	HIK	Hikma Pharmaceuticals PLC	▲25.1
2	OPHR	Ophir Energy PLC	▲20.6
3	GFRD	Galliford Try PLC	▲19
4	SIA	SOCO International PLC	▲11.3
5	ANTO	Antofagasta PLC	▲10.3
6	HNT	Huntsworth PLC	▲9.81
7	MGNS	Morgan Sindall PLC	▲9.74
8	ZTF	Zotefoams PLC	▲8.94
9	DJAN	Daejan Holdings PLC	▲8.56
10	ACA	Acacia Mining PLC	▲8.38

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	SPO	Sportech PLC	▼-46.1
2	GNC	Greencore Group PLC	▼-30.4
3	RNO	Renold PLC	▼-27.8
4	PZC	PZ Cussons PLC	▼-20.1
5	ISAT	Inmarsat PLC	▼-13.7
6	LSL	LSL Property Services PLC	▼-12.4
7	TCAP	TP ICAP PLC	▼-11.9
8	GMS	Gulf Marine Services PLC	▼-11.7
9	XAR	Xaar PLC	▼-10.9
10	PMO	Premier Oil PLC	▼-10

Somero Enterprises (LSE:SOM)

Share price: 375p

Mkt Cap: £211m

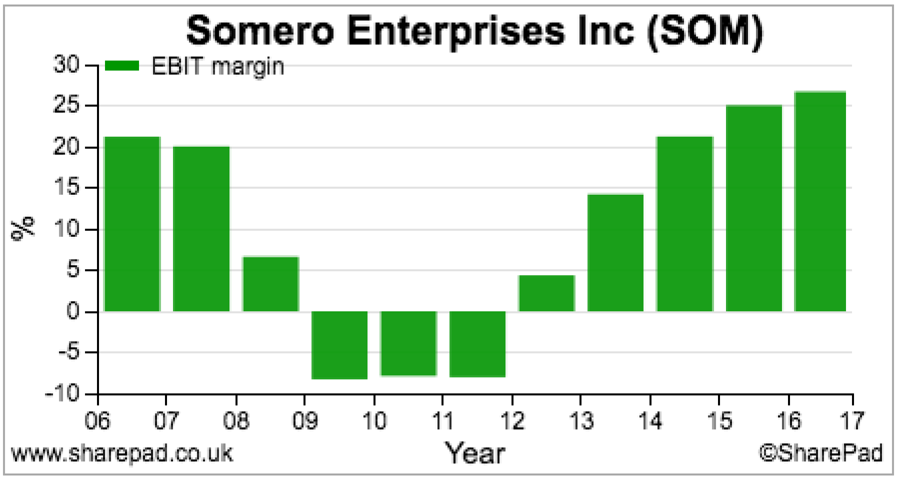
EMS: 1,500

No of analysts: 1

Somero is a manufacturer of concrete levelling equipment. Its screeding machines allow its users to install horizontal concrete floors faster, flatter and with fewer people. It is therefore attractive to building companies looking to do a better job in a more efficient way.

The company's shares have been on a stellar run since the beginning of 2016 as profitability has increased. Wednesday saw the company produce a record set of results in terms of profits and cash flows.

Building is a cyclical business and this has meant historically that demand for Somero's products has tended to be cyclical too. If we look at its profit margins, you can see that Somero has made losses in the past and that profitability has now passed the previous cyclical peak.



2017 saw another big improvement in profit margins from 26.7% to 29.7%. This was achieved on the back of a 7.9% increase in revenues and very good control of costs.

	Year ended December 31, 2017 US$ 000	Year ended December 31, 2016 US$ 000
Revenue	85,634	79,353
Cost of sales	36,870	34,270
Gross profit	48,764	45,083
Operating expenses		
Sales, marketing and customer support	10,426	10,056
Engineering and product development	1,222	1,071
General and administrative	11,683	12,768
Total operating expenses	23,331	23,895
Operating income	25,433	21,188

Record profits have been backed up by a very impressive cash flow performance. The only cash flow issue of note was a significant increase in accounts receivable or trade debtors. This can be a sign that a company is overtrading in an attempt to boost its profits. Somero has given a clear and encouraging explanation for this:

"The Company managed working capital effectively throughout the year, and even with the year-end increase to accounts receivable driven by particularly strong sales in December 2017, the overall increase in net working capital investment was in line with the growth in sales."

Consolidated Statements of Cash Flows

For the years ended December 31, 2017 and 2016

	Year ended December 31 2017 US$ 000	Year ended December 31 2016 US$ 000
Cash flows from operating activities:		
Net income	18,416	14,258
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred taxes	1,755	178
Depreciation and amortization	2,100	2,666
Bad debt	141	400
Amortization of deferred financing costs	38	32
Stock based compensation	467	725
Working capital changes:		
Accounts receivable	(4,657)	(110)
Inventories	63	(281)
Prepaid expenses and other assets	(112)	(293)
Other assets	(239)	(3)
Accounts payable, accrued expenses and other liabilities	1,282	278
Income taxes payable	566	(897)
Net cash provided by operating activities	19,820	16,953
Cash flows from investing activities:		
Proceeds from sale of property and equipment	202	71
Property and equipment purchases	(1,959)	(4,435)
Net cash used in investing activities	(1,757)	(4,364)

A fall in capex from $4.4m to just under $2.0m saw a significant increase in free cash flow of $12.5m to $18.8m. This compares with net income of $18.4m. This has allowed all of Somero's debt to be paid off and for it to announce a 40% increase in its dividend as well as a special dividend.

Despite these good results it is not unreasonable to ask how long Somero's buoyant financial performance can last?

The company remains heavily reliant on sales from North America which showed modest growth of just 2% in 2017, whilst sales in China - a key area for future growth - declined. Growth in Europe though was very strong.

Regional sales	US$ in millions	
	2017	2016
North America	57.8	56.6
Europe	12.2	8.0
China	5.5	6.4
Middle East	2.1	2.9
Latin America	2.3	1.7
Rest of World	5.7	3.8
Total	85.6	79.4

Whilst North American sales were quite subdued in 2017, there was a pick up in growth during the second half of the year. This has continued in 2018. Current trading in Europe is also very strong and broadly based amongst replacement products and demand for new technologies.

China remains the key area for disappointment for Somero. By its own admission it has taken longer than expected to gain a significant presence in this market. It is aiming at the quality end of the concrete flooring market but is struggling to break in. It is trying to do this by offering cheaper entry-level screeding machines aimed at customers seeking productivity improvements.

The hope is that these customers will trade up to more advanced machines in the future. If and when this will happen remains a major question mark for the long-term growth case for the company and its shares in my opinion.

Somero Enterprises Inc (SOM)

FORECASTS — £ millions unless stated

Year	2017		2018	
Turnover	61.1	+3.9%	64.0	+4.8%
EBITDA	19.9	+12.6%	20.8	+4.3%
EBIT	-		-	
Pre-tax profit	18.5	+17.6%	19.3	+4.2%
Post-tax profit	-		-	
EPS (p)	21.1	+14.0%	26.3	+24.7%
Dividend (p)	18.0	+102.8%	8.7	-51.4%

Broker forecasts are a bit thin on the ground with only one broker providing them. That said, 2018 should see another year of profitable growth according to the company.

At 370p, the shares trade on a one year forecast rolling PE of just under 14 times and offer an attractive yield of 5%. I find it difficult to know whether these shares are good value or not given how cyclical the business is and I'm not going to try and predict when the next building downturn will occur.

That said, the dividend income is an obvious attraction as is the promise of special dividends. These will occur if cash balances exceed $15m when half of the excess will be paid out.

Somero is clearly a very well run and highly profitable business at the moment. The fact that it is now debt free and targeting minimum cash balances of $15m takes away a degree of financial risk from shareholders and arguably makes the shares more attractive.

I was too downbeat about the shares when I looked at them last summer. However, I don't think it's unreasonable to say that the profit cycle is nearer the top than the bottom. Human beings tend to be lousy at predicting turning points but the shares are likely to remain well supported as long as trading remains good.

This is hardly me sticking my neck out but it's the best view I can muster at the moment as I've no idea how sustainable profits will prove to be.

XL Media (LSE:XLM)

Share price: 178p

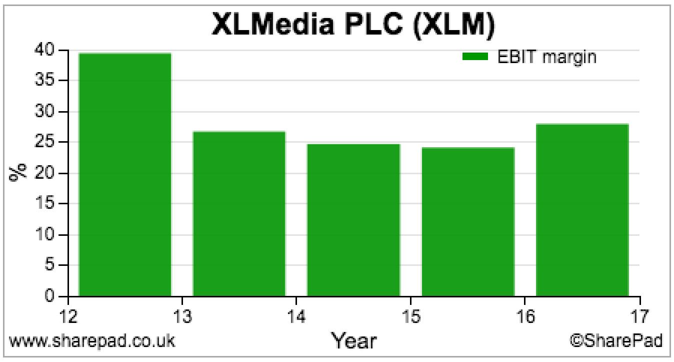
Mkt Cap: £392m

EMS: 5,000

No of analysts: 3

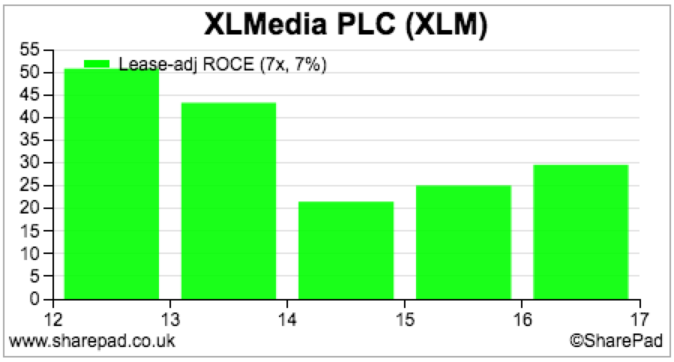
The shares of XL Media have been a very good investment since they listed on AIM just under three years ago. The company makes money from publishing content on over 2,300 websites which is intended to refer readers to gambling and personal finance websites.

For directing traffic to its customers' websites, XL Media gets paid a share of any money spent. This can come in the form of a fixed fee or a percentage of revenue or a combination of both. This has proven to be an extremely profitable business with direct profit margins (before central overheads) of 80%.



XL Media also makes money from buying adverts for its customers on search engines, websites and social networks. The aim is to direct people to its customers' or its own websites in return for a fee. This business made direct profit margins of 30% in 2017.

The company invests heavily in R&D and technology to continually improve its conversion of website visitors into revenue and to stay competitive.

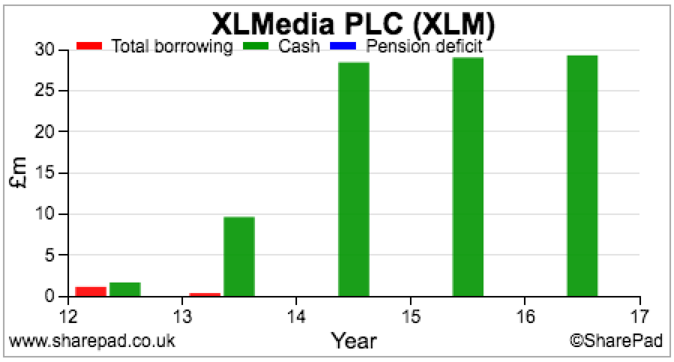


XL Media has been growing rapidly, both organically and by making lots of acquisitions. Most of its money is made in Europe - with a heavy Scandinavian bias - and North America. It is building up its presence in Asia.

Along with rapidly growing profits, the company's financial performance ticks a lot of boxes, It has high profit margins, high ROCE and no debts.

Despite its growth and attractive financial performance, I do have some concerns about this business.

One growing threat is increased regulation of gambling, online advertising and privacy. Regulation of gambling is a constant threat and could blow a hole in company profits if governments clamp down on it.



I also remain wary of advertising businesses.

Most customers hate advertising and there is a growing awareness amongst internet users how their online activities are tracked in order for others to make money. More internet browsers - even Google Chrome in a limited sense - are introducing features that improve users' privacy which can only make life more difficult for web advertisers in my opinion.

I will freely admit that I do not understand what XL Media's moat is - what protects its very high profits from competition. 80% direct margins from publishing are very high in anyone's book.

There is no doubt that the company has a huge number of publishing websites which give it credibility and clout with gambling companies. Its Palcon content management system also gives it an advantage but high profits tend to attract competition sooner or later if the business model can be copied or bettered.

The other thing I find puzzling is why a company with $33m of net cash, profits growth and strong free cash generation is raising equity - $43.6m in January - and cutting its final dividend payment.

I see the merits of having a debt-free balance sheet. Clearly the company still plans to buy up more website content and if it can earn good returns on acquisitions then raising equity is probably not an issue.

But does it show a lack of confidence about the future? Could it be that future profits are not sustainable enough to support even modest amounts of borrowing? A very small cut in the final dividend payment from 3.78 cents per share to 3.71 cents also puzzles me (given that EPS growth was 25%) and makes me think that it's not a sign of confidence.

Could it be that the company is making too many acquisitions? Having said that, most of the 37% sales growth from its Publishing division was from existing assets. Most of the growth from Media was from its acquisition of ClicksMob in February 2017.

On the numbers alone, XL Media looks to be a very attractive business. Its profits are backed by what appears to be genuine cash generation and the company is paying a dividend. The shares trade on a one year rolling forecast PE of 15.5 times and offer a forecast dividend yield of 3.3% at a share price of 176p. That's not expensive in many people's eyes.

XLMedia PLC (XLM)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	108.3	+1.3%	115.7	+6.8%	125.1	+8.2%
EBITDA	35.5		38.0	+6.9%	41.1	+8.3%
EBIT	31.2		33.4	+6.9%	35.7	+6.7%
Pre-tax profit	30.9	+1.1%	33.2	+7.5%	33.8	+1.7%
Post-tax profit	24.9	+5.6%	26.7	+7.3%	28.2	+5.9%
EPS (p)	11.3	-3.0%	12.1	+7.1%	12.9	+6.6%
Dividend (p)	5.9	-13.3%	6.3	+6.8%	6.9	+9.5%
CAPEX	0.9	-92.7%	0.5	-41.3%	0.5	-4.6%
Free cash flow	28.6	+69.4%	31.5	+10.0%	-	
Net borrowing	-58.2		-71.5	+22.9%	-107.0	+49.5%

Either this company is screamingly cheap or there is something that doesn't add up here. Are people concerned about Israeli AIM listed businesses? Do they lack confidence in the technology? Will regulation destroy the business model?

This is a share that goes in the too difficult pile for me.

Fevertree Drinks (LSE:FEVR)

Share price: 2807p

Mkt Cap: £3.2bn

EMS: 1,000

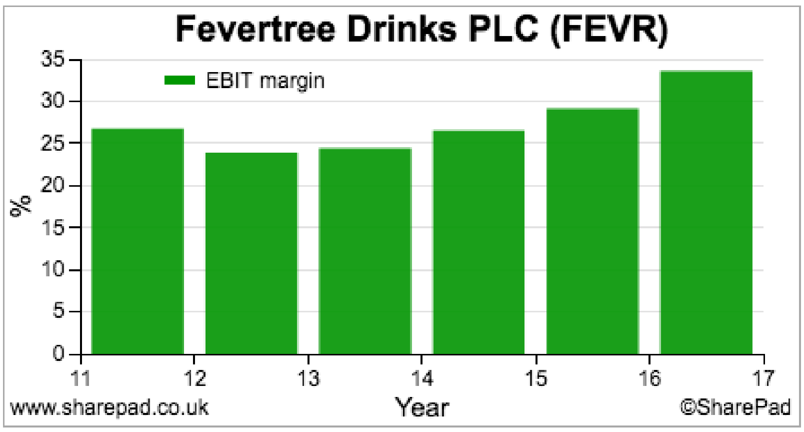
No of analysts: 5

Personally, I'm not a fan of Fevertree tonic water. It's not fizzy enough and it's too expensive. However, I think Fevertree Drinks is a fantastic business.

For me it represents a superb triumph of marketing and branding that has seen its bottles of premium mixers flying off supermarket shelves. It is now the dominant force in mixer drinks by value in the UK. However, some of this is due to the fact that its tonic can cost almost three times as much as Schweppes which still outsells it by volume.

2017 was another stellar year for the company with sales in the UK almost doubling and sales growing overall by 66%. Operating profits increased by 64% to produce an impressive operating margin of 33.1% which was a tiny bit lower than in 2016.

As well as having very popular products selling for very high prices, Fevertree benefits from an asset-light operating model. There are no factories, bottling plants or fleets of trucks sitting on its balance sheet. All manufacturing and distribution is outsourced to third parties. These are the secrets behind its high profit margins and ROCE.



My only issue with Fevertree's financial performance is its cash conversion. The company said that its Christmas trading was very strong but trade debtors increased by 83%, compared with sales growth of 66%, and saw £26.4m of cash flow out of the business.

	2017 GBP	2016 GBP
Operating activities		
Profit before tax	56,426,683	34,301,880
Finance expense	71,937	150,318
Finance income	(94,885)	(79,821)
Depreciation of property, plant and equipment	405,460	249,318
Amortisation of intangible assets	720,000	720,000
Share based payments	1,135,809	497,294
	58,665,004	35,838,989
(Increase) in trade and other receivables	(26,405,231)	(13,596,495)
(Increase) in inventories	(2,711,982)	(4,147,081)
Increase in trade and other payables	13,820,634	7,585,088
	(15,296,579)	(10,158,488)
Cash generated from operations	43,368,425	25,680,501

Fevertree's sales growth is phenomenal but the ratio of trade and other receivables to turnover increased from 29.7% to 32.7% in 2017. This compares with a similar ratio of just over 18% for the likes of Britvic and AG Barr.

This ratio needs watching in my view. It could be a sign that Fevertree is having to offer more generous payment terms (more time) in order to grow as fast as it is. It could also be nothing to worry about as long as the outstanding customer invoices get turned into cash.

Fevertree Drinks PLC (FEVR)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	195.7	+15.0%	231.9	+18.5%	252.3	+8.8%
EBITDA	61.5		73.1	+18.8%	79.7	+9.1%
EBIT	60.4		71.3	+18.1%	77.8	+9.1%
Pre-tax profit	59.4	+5.3%	70.0	+17.9%	71.5	+2.1%
Post-tax profit	47.8	+5.0%	56.9	+19.1%	61.9	+8.8%
EPS (p)	41.1	+5.0%	48.9	+19.0%	53.2	+8.8%
Dividend (p)	10.9	+2.3%	13.1	+20.2%	13.6	+3.8%
CAPEX	0.8	-35.4%	1.3	+60.0%	1.3	-2.1%
Free cash flow	43.8	+33.7%	51.1	+16.8%	59.5	+16.4%
Net borrowing	-81.7		-119.2	+46.0%	-165.7	+39.0%

Given that its shares trade on a forward rolling PE of over 65 times at a share price of 2807p, Fevertree remains under pressure to keep profits growing rapidly and faster than people expect. In recent years, the company has developed a habit for trading ahead of expectations which has kept pushing its share price to stratospheric heights.

The outlook statement in this week's results seems to have ended this trend:

"We have had an encouraging start to the year. Our first mover advantage, pioneering approach, brand strength, penetration and relationships means we are ideally positioned to be able to take advantage of the opportunities ahead."

This is hardly the kind of tone that gets analysts frantically rearranging their spreadsheets and the shares unsurprisingly sold off on Tuesday. However, they rallied hard on Wednesday.

Without continued profit upgrades, I think Fevertree's valuation is extremely frothy. To keep the share price motoring its needs to crack the US market and diversify its sales growth away from tonic water and into its cola and ginger ale mixers. This means not only wooing rum, vodka and whisky drinkers but taking on the mighty cola brands of Coca-Cola and Pepsi.

I expect the company to grow in the USA given its increased resources, new management and distribution deals there but I think it will be a much tougher market to crack.

As with gin, there is a growing trend towards premiumisation of vodka, rum and certain bourbon whiskies. But are these drinkers - particularly in the USA - going to mix their drinks with Fevertree cola instead of Pepsi or Coke? Maybe they will but I think this will prove to be a harder task than dislodging Schweppes tonic water in the UK. I'm more upbeat about the prospects for cola and ginger ale in Europe.

Whisky could also be a problem. Single malt whiskies tend to be mixed with a splash of water or drunk neat and not mixed with cola. Blended whiskies can be mixed with ginger ale but this tends to not be at the premium end of the market. Johnnie Walker Black Label is a premium blended scotch but is also mainly drunk neat, over ice or with mixers such as soda water. To me it would be a waste to mix this with cola as it would make it virtually indistinguishable from Bells.

I find little to dislike about Fevertree as a business. I only wish its tonic had as much fizz as its share price.