Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

13 April 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7258.34	▲0.817	▲0.604	▼-1.23	7778.64	6888.69	12/1/18	26/3/18
FTSE 250	19772.9	▲1	▼-1.71	▲1.8	20932.6	19187.1	5/1/18	26/3/18
FTSE SmallCap	5720.33	▲1.96	▼-1.49	▲4.36	6038.69	5445.09	15/1/18	20/4/17
FTSE AIM 100	5319.69	▲0.606	▼-2.42	▲15.5	5550.39	4601.22	29/1/18	18/4/17
FTSE All-Share	3996.54	▲0.89	▲0.138	▼-0.537	4268.89	3810.81	12/1/18	26/3/18
S&P 500	2667.15	▲0.162	▼-4.16	▲13.7	2872.87	2328.95	26/1/18	13/4/17
Brent Oil Spot $	$71.645	▲4.6	▲10.3	▲28.8	$71.945	$44.785	11/4/18	21/6/17
Gold Spot $ per oz	$1337.27	▲0.452	▲0.921	▲3.88	$1356.22	$1210.35	24/1/18	7/7/17
GBP/USD - US Dollar per British Pound	1.42318	▲1.61	▲2.35	▲13.4	1.42661	1.25047	1/2/18	13/4/17
GBP/EUR - Euros per British Pound	1.15545	▲1.05	▲2.53	▼-1.76	1.1972	1.0795	18/4/17	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	EVR	Evraz PLC	▼-11.9
2	JRS	JPMorgan Russian Securities ...	▼-9.88
3	PETS	Pets at Home Group PLC	▼-9.64
4	POLY	Polymetal International PLC	▼-9.43
5	SNN	Sanne Group PLC	▼-8.41
6	FXPO	Ferrexpo PLC	▼-8.27
7	MCS	McCarthy & Stone PLC	▼-7.77
8	ITE	ITE Group PLC	▼-6.79
9	SXX	Sirius Minerals PLC	▼-6.53
10	KNOS	Kainos Group Ltd	▼-6.18

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	OXIG	Oxford Instruments PLC	▲23
2	FGP	FirstGroup PLC	▲22.5
3	AA.	AA PLC	▲21.7
4	GNC	Greencore Group PLC	▲16.8
5	CARD	Card Factory PLC	▲15.9
6	MCRO	Micro Focus International PLC	▲15
7	LUCE	Luceco PLC	▲14.9
8	TSCO	Tesco PLC	▲14.9
9	MOSB	Moss Bros Group PLC	▲14.9
10	DFS	DFS Furniture PLC	▲14.5

Air Partner (LSE:AIR)

Share price: 82.7p

Mkt Cap: £43m

EMS: 3,000

No of analysts: 2

Up until Tuesday of last week, shareholders in Air Partner would probably have been reasonably happy about the state of their investment in the company. The company's share price had been on a very strong run for the previous two years. That run was brought to an abrupt halt when it announced that it had found some errors in its accounts dating back to 2011.

Between July 2011 and the end of January 2018, the company said it had so far estimated that £3.3m of uncollected receivables (unpaid invoices) were offset against deferred income balances (cash received in advance for future sales) instead of being expensed against revenues in the income statement.

In short, Air Partner has overstated its profits by an estimated £3.3m between these dates. During that period, it has made around £25m of cumulative operating profit. Most of the profit mis-statements relate back to 2011 according to the company.

The company made a further statement on Wednesday morning this week:

"At this stage, we believe that the total cumulative impact arising between the financial years ended 31 July 2011 and 31 January 2018 will not exceed GBP4m."

It also said:

"...underlying pre-tax profit for the financial year ended 31 January 2018 is expected to be not less than GBP6.4m".

With cash balances at the end of March of £8.6m confirmed and that the company had sufficient distributable reserves to pay a dividend the share price rallied strongly.

In the context of the company's cumulative profits, we are not talking about very significant profit errors here. That said, this is a black mark against the company's reputation and investors are quite rightly very upset about this.

When a company announces an accounting error like this there is always going to be a worry that there will be more bad news to come. This seems not to be the case now.

The company has made the comment that the error is a non-cash item which is true but this misses the point. The error has created a lack of trust in the company and this probably explains why the share price almost halved in value in the week following the announcement.

That said, issues such as this can give rise to significant profit-making opportunities for investors, provided the errors have been corrected, there are reassurances that they won't happen again and that current trading remains good. Air Partner shares have taken a huge bashing in the last week and now trade on a one year forecast rolling PE of just under 9 times at the time of writing with a share price of 82.7p.

Are Air Partner shares still worthy of consideration by long-term investors despite the strong bounce back in the share price?

The Business

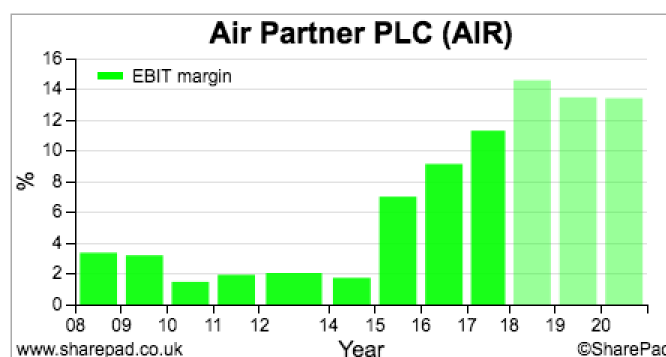
Air Partner makes the bulk of its money from chartering aircraft for its customers. It does not own any aircraft. Instead, it hires them from other companies in order to sell flights to commercial airlines, tour operators, football teams and industrial companies. It also has a significant private jet charter business and a small freight business.

In recent years the company has been diversifying its business away from aircraft broking or chartering. It has bought an aircraft remarketing business which involves selling and leasing aircraft for its customers. It has also bought an aviation safety consultancy and training business, a business specialising in fatigue management amongst pilots and a provider of environmental and air traffic control services.

Virtually all the company's profit still comes from its traditional chartering business at the moment.

Profitability & cash flow

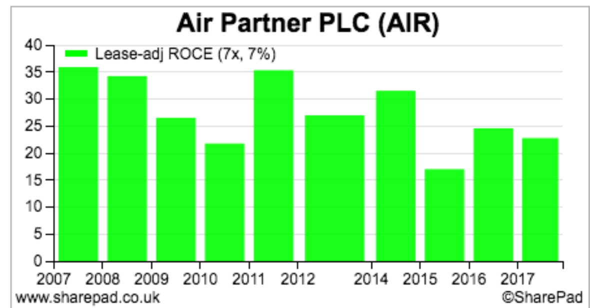
The accounting error and overstatement of previous profits does cloud the analysis of past profitability – much of it in 2011 according to the company - but let's have a look and see how the company measures up in terms of profit margins and return on capital employed (ROCE).



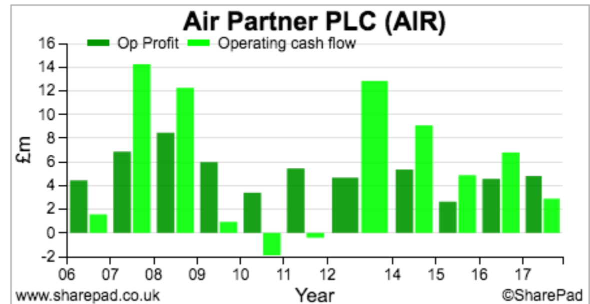
Profit margins have increased significantly in recent years and are expected to stay at a high level. Changes to margins forecast by analysts in 2019 and 2020 are possibly due to changes in the mix of the business going forward as the newly acquired businesses start making more profit.

Note the decline in margins between 2009 and 2010 which highlights that the business did suffer a fall in profitability during the last recession.

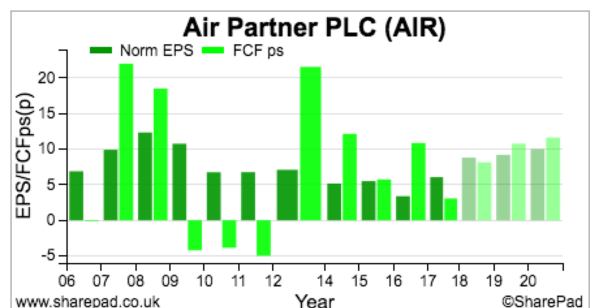
Air Partner is a people business and has virtually no tangible fixed assets. Capital employed is therefore a fairly low number consisting mainly of working capital, intangible assets and goodwill paid on acquisitions. ROCE has moved up and down over the last decade but has remained in excess of 15% - a sign of a pretty decent business.



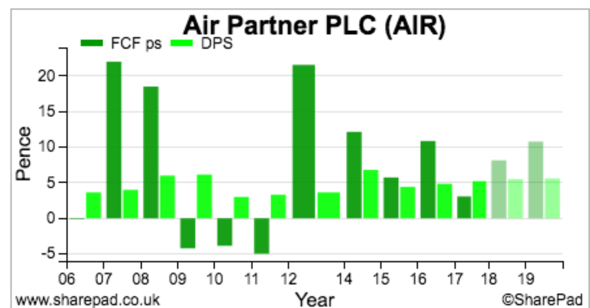
Cash conversion in recent years has been reasonable but was very poor between 2009 and 2011. The company's charter business has to pay for flights in advance and often sells on credit to win business from customers. This places a high working capital requirement on the business. The good news is that the private jet business is based on much more favourable cash flow characteristics with customers placing cash deposits in advance of using the service. These cash inflows are usually significant when economic conditions are good and tend to offset the working capital outflow demands of the charter business.



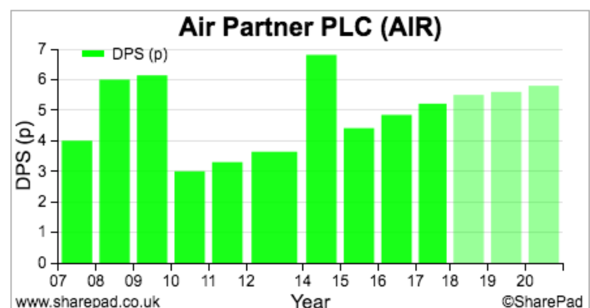
With little in the way of capex requirements, the conversion of earnings per share into free cash flow per share tends to follow the trends in operating cash conversion.



Free cash generation has been patchy and has not always been sufficient to cover the dividend payments.



The dividend was cut during the last recession and also in 2003 during the time of the Iraq war. This is a sign that the business is vulnerable to changes in the economy and the depressing effect this tends to have on air travel. There was no cut in 2015 as the 2014 dividend was for an 18 month period after changing the year end from July to January.



With the accounting issue hopefully settled, the underlying business remains in a good place. The Charter business has been performing very strongly with the push into the US private jet market paying off. Underlying pre-tax profits for the year to January 2018 are expected to have increased by at least 25%.

Despite the acquisition of new businesses, the outlook for growth in 2019 is currently more modest with a pick up currently expected in 2020.

Air Partner PLC (AIR)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	44.9	+5.5%	50.3	+12.0%	55.1	+9.5%
EBITDA	7.0	+25.1%	7.2	+3.2%	7.8	+8.5%
EBIT	6.5	+36.1%	6.8	+3.5%	7.4	+9.1%
Pre-tax profit	6.4	+34.8%	6.7	+4.2%	7.3	+9.2%
Post-tax profit	-		-		-	
EPS (p)	8.8	+45.2%	9.2	+4.5%	10.0	+8.7%
Dividend (p)	5.5	+5.5%	5.6	+1.8%	5.8	+3.6%
CAPEX	-		-		-	
Free cash flow	4.4	+165.1%	5.8	+32.2%	6.2	+7.9%
Net borrowing	-16.6	+11.9%	-19.0	+14.3%	-21.9	+15.0%

At the moment, there seems little reason to question these forecasts. However, visibility on charter business is low and is measured in days and weeks rather than months. Charters can be booked or cancelled at very short notice. Investors should continue to expect significant profit volatility in the years ahead.

The charter business is also very competitive and has low barriers to entry. Given this characteristic and the inherent cyclicality of the business it makes sense for the management to try and diversify the earnings streams of the business. That said, it's going to take time to do this in my view.

As I am writing (Wednesday morning), the share price is up by 32%. I think there is a good chance that this trend will continue and it would not surprise me to see virtually all the recent share price decline reverse over the coming weeks in the absence of any new developments.

I think Air Partner is a very solid business in a competitive and cyclical marketplace. These market characteristics would probably stop me from sticking its shares in my long-term portfolio but I do see how this could be a profitable opportunity for those with more of a short-term outlook.

Hostelworld (LSE:HSW)

Share price: 387p

Mkt Cap: £370m

EMS: 1,500

No of analysts: 4

Hostelworld doesn't own any hostels. Instead it is a middleman operating an online booking platform (websites and mobile apps) that connects hostel owners with young travellers. Hostelworld gets paid commissions – currently in the form of customer deposits – in return for processing the bookings.

Its main costs are marketing, staff and administrative costs. Its investment is in the website domain names across the world and the technology to run them. The business is seasonal with most of the group's bookings peaking in the key European holiday season between May and August.

The company's shares have performed well since it listed on the stock exchange in late 2015. 2017 saw it produce a solid set of figures with operating profit growth of 10.5% but on closer inspection it seems that all is not as well as it might first appear.

One of the most revealing things you can find out when you read a set of full year results is to look at the trends in growth and profit margins in the second half of the year. The company sometimes tells you this information but more often than not you have to work it out for yourself. This is not very difficult to do. You just subtract the first half's figures from the full year ones. This can be done fairly quickly in a spreadsheet as shown below.

Hostelworld €m	H1 16	H216	FY16	H117	H217	FY17
Revenue	40.2	40.3	80.5	46.6	40.0	86.7
Adjusted EBITDA	10.1	13.8	23.9	12.9	13.5	26.4
Depreciation	-0.5	-0.4	-0.9	-0.5	-0.6	-1.1
Amortisation of dev costs	-1.6	-1.6	-3.2	-1.6	-1.3	-2.9
Share based payments	-0.1	-0.3	-0.4	-0.4	-0.2	-0.6
Adjusted operating profit	**7.9**	**11.5**	**19.4**	**10.4**	**11.4**	**21.8**
Revenue growth				16.1%	-0.8%	7.6%
Profit growth				27.7%	-2.2%	10.5%
Operating margin	19.7%	28.5%	24.1%	22.3%	28.5%	25.2%

Hostelworld is one of the many companies that talks about adjusted EBITDA a lot which immediately makes me wary. It is also one of an increasing number of companies that seems to think that share-based payments can be ignored because they are a non-cash item. I disagree with this as for me being paid in shares is no different from being paid in cash – it is a cost of doing business and should not be ignored.

These criticisms aside, the company's financial performance is more than reasonable on many measures.

The company does not disclose an adjusted operating profit number so I've calculated it in the table above. At first glance the numbers look fairly good. Revenues are up by 7.6%, operating profits are up by 10.5% and profit margins have increased to 25.2% which shows an attractive level of profitability.

However, we can see that there has been a significant slowdown in the second half of the year. Both revenues and profits fell slightly.

Hostelworld €m	**H1 16**	**H216**	**FY16**	**H117**	**H217**	**FY17**
Bookings Hostelworld (m)	3.0	3.2	6.2	3.6	3.4	7
Other bookings(m)	0.5	0.4	0.9	0.3	0.2	0.5
Total bookings(m)	3.5	3.6	7.1	3.9	3.6	7.5
Average booking value (€)	11.8	11.4	11.6	12.2	11.0	11.6
Net revenue (€m)	40.2	40.3	80.5	46.6	40.1	86.7
Hostelworld bookings growth				**20.0%**	**6.3%**	**12.9%**
Other bookings growth				**-40.0%**	**-50.0%**	**-44.4%**
total bookings growth				**11.4%**	**0.0%**	**5.6%**
Change in average booking value				**3.4%**	**-3.5%**	**0.0%**

We can also see that there was a sharp slowdown in the core Hostelworld brand's booking and a decline in the average booking value (based on my estimates).

The company to its credit is very open about this in its results press release. It blames the slowdown on the changes in demand seasonality between 2016 and 2017 (I am not sure I understand what that means) and geopolitical events. The weakness of the US dollar against the Euro has made Europe a more expensive destination for US travellers as well and has dampened demand from them.

The weakness in the average booking value has come despite yield initiatives – such as getting hostel owners to pay more to increase their prominence in search lists – which saw the average commission rate increase from 13.8% to 14.3% but this was offset by a lower number of beds per booking and exchange rate movements.

Hostelworld margin analysis

Hostelworld	2016	2017
Revenue	100.0	100.0
Marketing costs	40.8	38.2
Credit card fees	2.4	2.4
Staff costs	17.8	20.2
Other admin	9.9	9.6
Depreciation	1.1	1.2
FX gain	-0.3	-0.1
Amort of dev costs	4.0	3.4
Total costs	75.8	74.8
Operating profit	24.2	25.2

The company has done some good work in order to improve its profit margins to 25.2%. Marketing costs as a percentage of sales have come down significantly due to more direct sales and some currency benefit as most of the marketing costs are in US dollars. This offset a rise in staff costs from a new software development centre in Portugal.

Free cash generation was again good and increased from €18.3m to €21.5m mainly due to higher profits. This represented a free cash flow conversion ratio of nearly 100% which is good to see. This is more than sufficient to cover the total dividend cost for the year of €16.3m– up by 13% on a per share basis.

I think Hostelworld has many desirable characteristics. It has high profit margins and a ROCE of just under 15%. Free cash flow generation is good, it has no debt and pays a decent dividend. My only caution would be that the growth outlook is not particularly inspiring in the short term. An independent study by Phocuswright has predicted that the global hostel market will grow its revenues at an average annual rate of 5% until 2020. Hostelworld will aim to do better than this by offering new services to increase its commission rate.

Hostelworld Group PLC (HSW)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	77.7	+2.2%	83.7	+7.7%	90.4	+8.0%
EBITDA	22.2		25.1	+12.8%	27.5	+9.8%
EBIT	19.1		21.2	+10.7%	23.0	+8.4%
Pre-tax profit	13.9	+33.7%	16.1	+16.4%	24.1	+49.2%
Post-tax profit	17.2	+82.3%	19.5	+13.5%	21.1	+8.3%
EPS (p)	18.2	+85.7%	20.1	+10.0%	21.8	+8.7%
Dividend (p)	14.1	-6.8%	15.4	+9.3%	16.9	+9.6%
CAPEX	1.0		1.0	0.0%	1.1	+7.1%
Free cash flow	-		-		-	
Net borrowing	-23.5		-29.6	+25.8%	-38.3	+29.4%

The company's outlook statement is not particularly bullish:

"*Market conditions, **particularly in Europe, remain uncertain and while volume bookings in the first quarter of 2018 are in line with expectations, weaker exchange rates, particularly for the US dollar, remain a significant headwind.***

*We continued our program of pricing initiatives in Q1 2018, with changes to base rate commissions making a **positive contribution to ABV.***

In addition, the pilot launch of our new free cancellation booking option in February 2018, resulted in a noticeable increase in conversion and booking levels. We therefore plan to introduce this model more widely, which we see as a key strategic move for the business. ***We anticipate this product to be earnings enhancing in the medium term but will result in a deferral of revenue recognition which will impact reported earnings in 2018, its first year, but will not impact on cash receipts.***

This new product together with increased technology investment will substantially improve our offering to customers and our competitive position and underpins the Board's confidence that we will see bookings growth in 2018 and beyond."

This looks like a backdrop for very modest growth to me. That said, SharePad consensus EPS (currently priced In pounds but will soon be moving to reporting currencies) of 18.2p looks too low to me. Given an average exchange rate of £1=€1.14 this would equate to EPS of €0.2075 compared with €0.2275 just reported. It's not impossible for EPS to fall year on year but at the moment I'd be surprised if that was the case. I therefore see scope for consensus EPS forecasts to move up.

That said, at 387p the shares trade on a trailing PE of just under 20 times. Given the uncertain growth outlook I can’t see much scope for the shares to command a higher valuation at the moment.

Card Factory

Share price: 222p

Mkt Cap: £758m

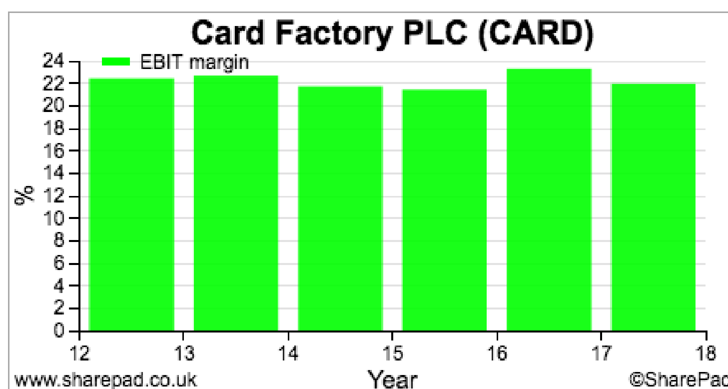
EMS: 1,500

No of analysts: 5

The shares of Card Factory have been going through a very rough patch for the last six months. Unlike many high street retailers, growing sales has not been a problem for this company. Its chief problem has been a rising cost base, particularly wages.

It's very easy to dismiss a business like Card Factory and think that the market for sending greetings cards is a declining one. In fact, it remains quite resilient with no noticeable shift towards digital cards. Card Factory remains the leading business in this sector.

By making its own cards it has a significant cost advantage over its competitors which allow it to sell cards at very low prices and make very attractive margins from doing so. Most retailers can only dream of having profit margins of nearly 20%.



Sales growth of 6.3% - including like-for-like sales growth of 2.6% from the company's stores - was not enough to offset a big increase in costs last year. Despite average staff numbers being broadly unchanged year on year, staff costs increased by 7.8% mainly due to increases in the average living wage. A rise in import costs caused by exchange rates, and growth in non-card sales which have lower margins, all contributed to profit margins falling from 22% to 19.8%.

Some of my fears I expressed when commenting on Card Factory's interim results back in September have not materialised. The big build up in stocks seen in the first half of the year has not caused a problem with year-end stock balances unchanged year on year.

Operating cash flow fell by nearly 10% to £89.7m which compared favourably with underlying operating profits of £83.3m. Higher capex meant that free cash flow was down by over 17% to £57m (£68.9m). Despite this, the company remains capable of paying big dividends to shareholders.

Strong free cash flow generation has underpinned a series of special dividends from Card Factory in recent years. With free cash flow expected to be slightly lower again at £54.9m in 2019 – on the back of flat operating profits – the scope for bigger payments has diminished.

Card Factory PLC (CARD)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	447.1	+5.9%	470.8	+5.3%	490.5	+4.2%
EBITDA	94.3		98.9	+4.9%	100.2	+1.3%
EBIT	83.7		86.5	+3.3%	87.3	+0.9%
Pre-tax profit	79.7	+9.8%	83.8	+5.1%	84.2	+0.5%
Post-tax profit	64.9	+10.3%	66.6	+2.7%	68.3	+2.5%
EPS (p)	18.7	+8.4%	19.7	+5.3%	20.1	+2.0%
Dividend (p)	17.2	+84.9%	18.7	+8.7%	18.2	-2.7%
CAPEX	14.0		12.3	-11.8%	12.5	+1.2%
Free cash flow	54.3		66.3	+22.1%	64.1	-3.3%
Net borrowing	161.8		154.5	-4.5%	145.0	-6.1%
NAV	-		-		-	
Like for like sales growth %	2.0		1.5	-25.0%	-	

The company paid out a special dividend of 15p per share in 2017. This is likely to fall to 5-10p in 2019. Assuming an underlying dividend per share of 9.3p in 2019 it seems that city analysts are currently predicting a special dividend of around 7.9p per share. All these dividends would cost just under £59m which would consume all the company's expected free cash flow but shouldn't see net borrowings change that much.

At 222p, the shares have a forecast underlying dividend yield of 4.2% increasing to 7.8% including the expected special dividend. A special dividend of around 8p per share going forward looks affordable and sustainable as long as profits and free cash flow holds up.

Trading in the current year has started reasonably well with record seasonal performances from card sales for Valentine's Day, Mother's Day and Easter. Despite this, cost pressures remain but the company is confident of finding supply chain efficiencies to offset them.

Surprisingly, the company is still talking about opening another 50 stores this year as it continues to target 1200 (915 at the end of 2017). I'm not sure that this is a great idea as increasing exposure to bricks and mortar stores looks increasingly like a risky strategy these days. Yet the company believes that it can exploit the current turmoil on the high street and pick up some attractive sites.

I find it difficult to get excited about a business like Card Factory but it is difficult to dispute that it remains highly profitable and cash generative. The dividend remains attractive whilst the valuation of the shares at 11.8 times forecast rolling EPS is not expensive.

The shares have bounced on the relief that trading has held up well and that special dividends – albeit smaller ones – are still going to be paid. The shares look attractive for their income but I wouldn't bet on a big upwards rerating from the current share price.