

Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users



20 April 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7328.92	▲0.972	▲4.06	▲3.02	7778.64	6888.69	12/1/18	26/3/18
FTSE 250	20147.2	▲1.89	▲2.3	▲3.76	20932.6	19187.1	5/1/18	26/3/18
FTSE SmallCap	5808.69	▲1.54	▲2.05	▲6.6	6038.69	5445.09	15/1/18	20/4/17
FTSE AIM 100	5348.87	▲0.549	▼-2.39	▲16.2	5550.39	4601.93	29/1/18	19/4/17
FTSE All-Share	4042.3	▲1.14	▲3.69	▲3.26	4268.89	3810.81	12/1/18	26/3/18
S&P 500	2693.76	▲1.12	▼-0.706	▲15.2	2872.87	2338.17	26/1/18	19/4/17
Brent Oil Spot \$	\$74.59	▲3.34	▲12.8	▲40.5	\$74.59	\$44.785	19/4/18	21/6/17
Gold Spot \$ per oz	\$1342.06	▲0.313	▲1.89	▲4.88	\$1356.22	\$1210.35	24/1/18	7/7/17
GBP/USD - US Dollar per British Pound	1.4196	▼-0.303	▲1.22	▲11.1	1.43407	1.26325	16/4/18	20/6/17
GBP/EUR - Euros per British Pound	1.1498	▼-0.442	▲1.14	▼-3.61	1.1947	1.0795	20/4/17	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	AA.	AA PLC	▲36.1
2	ENQ	EnQuest PLC	▲25
3	LUCE	Luceco PLC	▲16.7
4	MDC	Mediclinic International PLC	▲16.2
5	VEC	Vectura Group PLC	▲15.5
6	SPO	Sportech PLC	▲15.1
7	HOC	Hochschild Mining PLC	▲14.7
8	PMO	Premier Oil PLC	▲13.5
9	KNOS	Kainos Group Ltd	▲13.2
10	JD.	JD Sports Fashion PLC	▲10.9

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	RNO	Renold PLC	▼-13.4
2	BATS	British American Tobacco PLC	▼-12.6
3	TEP	Telecom plus PLC	▼-10.9
4	FOXT	Foxtons Group PLC	▼-9.02
5	INTU	Intu Properties PLC	▼-7.76
6	SGE	Sage Group (The) PLC	▼-6.25
7	SMWH	WH Smith PLC	▼-6
8	KMR	Kenmare Resources PLC	▼-5.43
9	IMB	Imperial Brands PLC	▼-4.52
10	IGG	IG Group Holdings PLC	▼-4.49

Whitbread



Whitbread shares have been stuck in something of a rut around the £40 mark since early 2016. Three years ago they peaked at over £54. The shares have fallen out of favour as concerns have grown over the sustainability of profits at Costa Coffee and rising levels of competition facing its Premier Inn budget hotel chain.

The lacklustre share price has attracted the attention of two activist investors in recent months. Just before Christmas, Sachem Head acquired just over a 3% stake in Whitbread. It argued that the shares were substantially undervalued based on the valuations of other coffee and hotel businesses. It also cited that there was substantial property value within Premier Inn's freehold sites that could be paid out to shareholders via a sale and leaseback transaction.

This week, Elliott, a renowned activist investor announced that it has bought up 6% of Whitbread's outstanding shares. It too argued that Whitbread shares are substantially undervalued and that the business should be broken up by spinning off one of the businesses in order for their true values to be realised.

The view that Whitbread's shares are cheap is based on the view that if its two businesses were valued at similar multiples of profits to other traded coffee and hotel businesses its share price would be a lot higher.

I agree with the view that coffee shops and budget hotels don't need to be owned by the same company. I think the idea of selling off hotels, paying the cash to shareholders and taking on lots of debt is a silly one and would definitely make the business less attractive (freehold ownership gives valuable flexibility to a business) and riskier.

TIDM	Name	Close	Market Cap. (m)	PE roll 1	Enterprise value / fc Norm EBIT	EBIT margin	ROCE
IHG	InterContinental Hotels...	£42.25	£8027.1	20.5	16.865	46.6	42.8
SBUX	Starbucks Corp	\$59.43	\$83653.7	22.4	18.249	19.7	43.4
WTB	Whitbread PLC	£42.18	£7735.2	15.8	14.713	19.2	15.2

I've used SharePad to give me some indication of the value of some comparator businesses. For hotels, I've used InterContinental Hotels (IHG) and for coffee I've used Starbucks. SharePad has calculated the forecast EV/EBIT multiple for these companies and I've applied these to Whitbread's trailing twelve-month profits for Costa and Premier Inn with central overheads allocated based on their share of group revenues.

Ideally, I'd like to use forecasts for Costa and Premier Inn but I'm very close to current consensus 2019 EBIT forecast of £648m so I'm not too concerned about this. I am also being generous to Whitbread by using TTM net borrowings whereas forecasts are higher.

Applying comparator EBIT multiples to Costa and Premier Inn can get me an estimated break-up value (sometimes referred to as the sum of the parts - SOTP) for Whitbread of 5358p compared with a share price at the time of writing of 4200p. Whitbread looks very undervalued on this basis.

Whitbread plc SOTP	EBIT	EV/EBIT multiple	Reason	Implied EV
Hotels	466.1	16.90	Same as IHG	7877
Costa	174.5	18.20	Same as Starbucks	3176
Estimated Enterprise Value				11053
less:				
Net borrowings				-852.4
Pension deficit				-374.5
Estimated Equity Value				9826
Shares in issue (m)				183.4
Value per share(p)				5358

But is it? Just because an activist investor argues that Whitbread shares are cheap doesn't mean that it is true. If you can, you should always try and work things out for yourself.

Why should Costa and Premier Inn be valued at the same multiple of profits as Starbucks and IHG?

Costa is still predominantly a UK-based business. There is a growing consensus view that the country is saturated with coffee shops, yet Costa keeps opening more of them. The risk of sales cannibalisation is very high if it is not happening already. One thing is for certain: Costa's operating profits did not grow at all between March and September last year. It is unlikely to have grown much between September and March in my view.

In contrast, Starbucks is ticking along quite nicely and is expected to deliver reasonable rates of growth going forward according to SharePad forecasts. Why should Costa with lacklustre profits growth be valued as highly as Starbucks?

Starbucks Corp (SBUX)
FORECASTS

\$ millions unless stated

Year	2018		2019		2020	
Turnover	24,799.8	+10.8%	27,130.3	+9.4%	29,632.9	+9.2%
EBITDA	5,752.7	+5.0%	6,416.2	+11.5%	7,196.1	+12.2%
EBIT	4,664.9	+5.8%	5,225.7	+12.0%	5,878.0	+12.5%
Pre-tax profit	4,746.9	+9.9%	5,189.4	+9.3%	5,751.8	+10.8%
Post-tax profit	3,509.9	+17.5%	3,853.8	+9.8%	4,255.7	+10.4%
EPS (£)	248.8	+26.3%	279.5	+12.3%	316.1	+13.1%
Dividend (£)	125.6	+19.6%	138.9	+10.6%	155.4	+11.9%
CAPEX	1,978.6	+30.2%	1,954.8	-1.2%	2,066.0	+5.7%
Free cash flow	2,894.1	+9.0%	3,209.2	+10.9%	3,544.0	+10.4%
Net borrowing	4,080.8	+177.6%	5,539.6	+35.7%	6,807.7	+22.9%

Applying discounts to valuations is a somewhat arbitrary process. But a 25% discount to Starbucks would reduce the break-up value to 4930p. Again, this still suggests that Whitbread shares are undervalued at the current share price.

Whitbread plc SOTP	EBIT	EV/EBIT multiple	Reason	Implied EV
Hotels	466.1	16.90	Same as IHG	7877
Costa	174.5	13.70	25% discount to Starbucks	2391
Estimated Enterprise Value				10268
less:				
Net borrowings				-852.4
Pension deficit				-374.5
Estimated Equity Value				9041
Shares in issue (m)				183.4
Value per share(p)				4930

I think Premier Inn is Whitbread's best business. It offers a very good product at a fair price and this is why customers like it so much. But is it as good a business as IHG? I don't think so.

Whitbread owns and manages Premier Inn in the UK with aspirations to build a big business in Germany. Premier Inn makes good returns on capital of around 15%. IHG franchises its hotels and operates an asset-light business model across the world. It is focusing more on the premium end of the hotel market but the business remains underpinned by its mid-market Holiday Inn brand. IHG has fantastic returns on capital and profit margins and should steadily grow its profits going forward.

I think some kind of discounted valuation is appropriate for Premier Inn as well. A 10% discount to IHG still gives me a break up value of around £45 for Whitbread.

Whitbread plc SOTP	EBIT	EV/EBIT multiple	Reason	Implied EV
Hotels	466.1	15.20	10% discount IHG	7085
Costa	174.5	13.70	25% discount to Starbucks	2391
Estimated Enterprise Value				9475
less:				
Net borrowings				-852.4
Pension deficit				-374.5
Estimated Equity Value				8248
Shares in issue (m)				183.4
Value per share(p)				4498

I think Whitbread shares are probably undervalued as long as profits hold up. The company now looks as if it is definitely in play as a break-up candidate and it looks as if it will become increasingly difficult for the current management team to resist the pressure to spin off one of its businesses. The company reports its full year results next Wednesday (25th April).

Associated British Foods



ABF is a food producing and retail conglomerate. The company is dominated by its value clothing retailer Primark. It has five main sources of operating profits:

- **Grocery (21%)** - Consisting of many popular household grocery brands such as Ovaltine, Twinings, Kingsmill, Allinsons, Silver Spoon sugar, Jordans Cereals, Ryvita, Pataks, Mazola and George Weston Foods in Australia.
- **Sugar (15%)** - The growing and processing of sugar beet and sugar cane. ABF owns British Sugar as well as Illovo, the largest sugar producer in Africa. It also has sugar businesses in Spain and China.
- **Agriculture (4%)** - Manufacture of animal feeds and other agricultural products and services.
- **Ingredients (9%)** - Manufacture of bakers' yeast and other baking ingredients.
- **Retail (51%)** - Selling value clothing through Primark and Penneys retail chains

ABF's shares have been struggling for the last couple of years since peaking at £36 as growth at Primark has been offset by falling profits in the company's sugar business. This week's interim results showed that trend continuing.

ABF Half year analysis	Revenue		Adj Op Profit		Margin	
Division (£m)	2018	2017	2018	2017	2018	2017
Grocery	1672	1658	159	151	9.5%	9.1%
Sugar	938	1081	90	123	9.6%	11.4%
Agriculture	615	552	24	23	3.9%	4.2%
Ingredients	720	730	63	61	8.8%	8.4%
Retail	3477	3222	341	323	9.8%	10.0%
Central	0	0	-29	-31		
Total	7422	7243	648	650	8.7%	9.0%

Overall, there was no operating profit growth from the business. Grocery has been reasonably solid due to an improvement in operating margins on a modest increase in revenues. Yet it was the fall in sugar profits that offset the profits growth in Grocery and Primark.

To be fair to ABF, it has been very upfront about the volatility of its sugar profits and so the fall should not have surprised them. That said, this is a business that will continue to dilute the quality of ABF's profits in the future in my view.

The ending of the EU sugar regime last year has removed sales quotas and restrictions on exports. When this has been combined with a good harvest, there is too much sugar on the market and prices have fallen which has fed through to lower profitability.

Elsewhere within the sugar business, profits at Illovo in Africa are not expected to grow in 2018 but Chinese sugar profits should increase.

Primark is doing reasonably well but is not growing at the rates seen in previous years as the business matures. Selling space has increased by 9.2% over the last year but sales growth lagged this at 7.9%.

The UK business has been the best performing part of Primark with like-for-like sales growth of 3% but overall LFL sales across the business actually fell by 1.5% - blamed on bad weather in October 2017 – and profit margins came down slightly. Reassuringly, stock control was good over the key Christmas period with no damaging stock write offs.

Selling space growth is expected to be 8.6% for the year to September 2018 which will take the size of the business to over 15 million square feet which should keep the top line growing. Profit margins are also expected to improve due to better buying and a boost from the strengthening of the pound which makes imported clothes cheaper.

Primark is a very good business and has a selection of products that are very popular with customers but sales growth is likely to be more modest in the future. Its store base is maturing and this natural source of growth is slowing down. It is also worth noting that Primark experienced very buoyant trading in summer 2017 and this will be a tough benchmark to grow against.

That said, in a world of many cash-strapped consumers it has built up a market position that will be hard for competitors to dislodge it from. It also has a significant platform for growth outside the UK which now accounts for over half of its selling space. If Primark retains its commitment to price leadership whilst maintaining margins of around 10% then it will be in a good place.

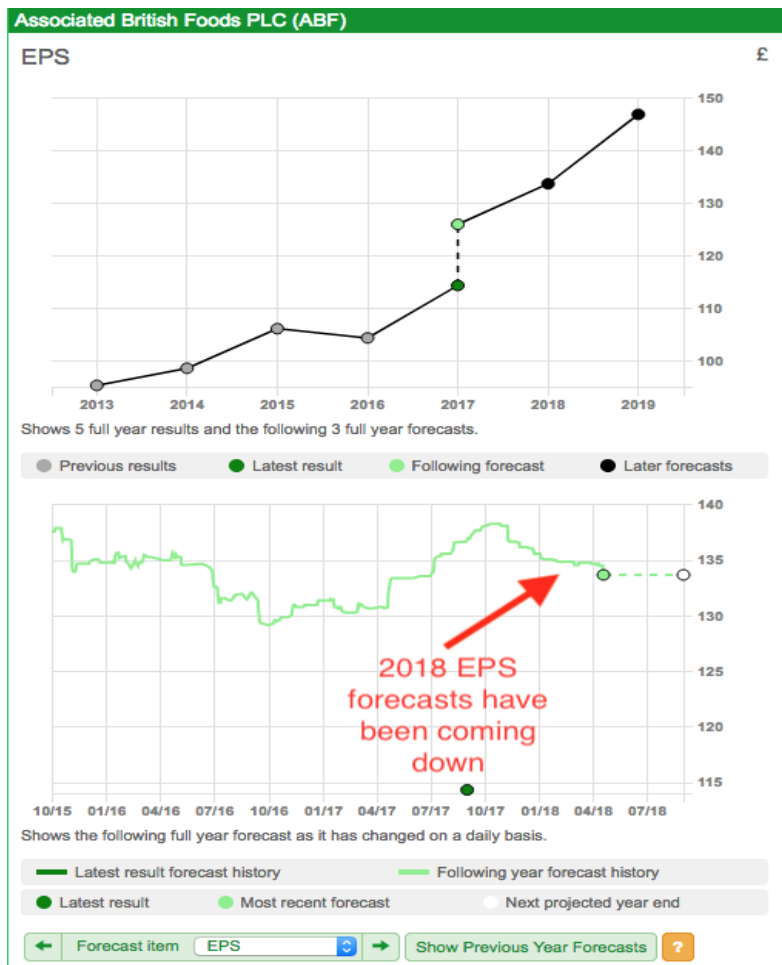
Primark selling space

	HY 18		HY 17	
	# of stores	sq ft 000	# of stores	sq ft 000
UK	184	6,987	176	6,622
Spain	44	1,675	42	1,565
Germany	25	1,587	22	1,401
Republic of Ireland	37	1,084	37	1,084
Netherlands	18	850	16	770
France	12	607	10	503
USA	8	485	6	375
Portugal	10	348	9	300
Austria	5	242	5	242
Belgium	5	227	4	166
Italy	4	203	2	99
	352	14,295	329	13,127

I am not really sticking my neck out too much by stating that I think that Primark will be a more intrinsically valuable business in five years' time but does that mean that ABF shares are attractively valued today?

Associated British Foods PLC (ABF)						
FORECASTS			£ millions unless stated			
Year	2017		2018		2019	
Turnover	15,190.0	-1.1%	15,933.1	+4.9%	16,880.1	+5.9%
EBITDA	1,854.0	-2.1%	1,908.8	+3.0%	2,129.2	+11.5%
EBIT	1,355.9	+2.6%	1,401.5	+3.4%	1,528.4	+9.0%
Pre-tax profit	1,299.4	+1.4%	1,360.9	+4.7%	1,511.4	+11.1%
Post-tax profit	990.9	+9.6%	1,059.8	+7.0%	1,162.2	+9.7%
EPS (p)	126.0	+10.2%	133.7	+6.1%	146.9	+9.9%
Dividend (p)	41.6	+1.5%	42.5	+2.2%	49.0	+15.3%
CAPEX	802.4	-7.3%	836.5	+4.2%	878.5	+5.0%
Free cash flow	847.3	+7.8%	717.8	-15.3%	883.7	+23.1%
Net borrowing	-577.9	-14.1%	-819.6	+41.8%	-1,258.3	+53.5%
NAV	7,695.0	-7.7%	-	-	-	-

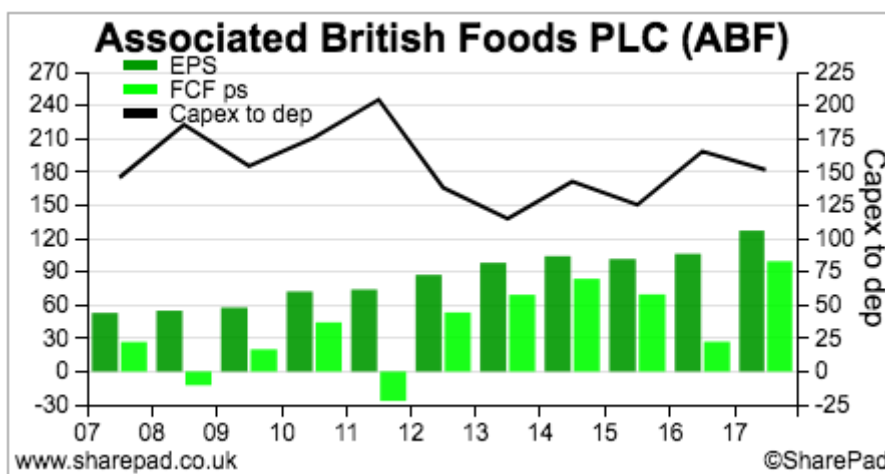
The outlook for EPS growth looks alright but is nothing stellar and depends to some extent on the volatility of sugar profits. Also, profit forecasts for 2018 have been coming down in recent weeks as shown in the chart below.



Two thirds of ABF's profits are made outside the UK. Currency tailwinds – from the previous weakness of the pound – have become headwinds as the pound has strengthened in recent weeks and this could see further forecast downgrades in the coming months.

I wouldn't mind owning a slice of Primark as well as ABF's portfolio of popular grocery brands. I'm not sure I'd want the baggage that sugar brings whilst the ingredients and agriculture business are not going to grow significantly to make a huge difference to ABF's valuation in my view.

However, ABF's shares have been significantly de-rated over the last couple of years. Despite the profit and cash flow volatility that comes from sugar and the working capital employed in this business, the business still generated a lease-adjusted ROCE of more than 13% last year and has reasonable - not great - free cash generation given its capex spending.



The current rolling one year forecast PE is just under 21 times. That's probably not attractive enough for most people but ABF is a share that would interest me in the event of a stock market pullback.

Netflix



Like an increasing number of people, I have largely given up watching live TV. The only live viewing in my household tends to be sport and very little else. For drama, films and kids' programmes we have Netflix along with another 125 million subscribers across the world.

I am a big fan of Netflix. For less than £10 per month, my family can stream programmes and films over the internet at the same time, on different devices and with no adverts. I think it is fantastic value for money compared with the £150 per year licence fee and most of the ad-riddled stuff on commercial channels.

An increasing number of people across the world are taking the same view. They want to be in control of what they watch, when they watch it and on a media streaming device of their choice. First quarter results released this week revealed that Netflix is growing at its fastest rate ever.

It added 7.4 million net new streaming customers in the quarter with average customers 25% higher on a year-on-year basis. The company is also increasing its prices at the same time with average selling prices 14% higher than a year ago. This translated into a 40.4% increase in revenue and 63% increase in net income.

The company is forecasting the second quarter to be even better with a revenue increase of 41.2%. Netflix is spending huge amounts of money in order to achieve this rate of growth but so far it seems to be bearing fruit. Netflix shares are up by an astonishing 75% since the start of 2018 and trade on a very punchy one year forecast rolling PE ratio of 98.4 times at a share price of \$336.

Netflix is now so deeply entrenched in many homes, it begs the question as to what can stop this media juggernaut? In the short run it seems not a lot. It has agreed to become part of bundled packages offered by big pay TV operators such as Sky and Comcast. If it keeps adding 25 million subscribers a year and is able to keep increasing prices – from its current low base – then I can begin to understand some of the reasons why so many investors have been buying the shares recently.

That said, this is a business that still has to allay concerns. Netflix is still heavily reliant on third party providers for its content, despite investing heavily in its own productions. It will spend \$7.5-8bn this year on content and currently has outstanding content obligations of \$17.9bn.

Netflix is clearly an attractive source of growth for many content providers but there are signs of a backlash as it becomes a threat to their own businesses. Disney will withdraw its content from Netflix in 2019 as it attempts to build its own streaming business. Netflix is also no longer present at the Cannes film festival as there is a new rule which says that films cannot be shown on Netflix in France until three years after the festival.

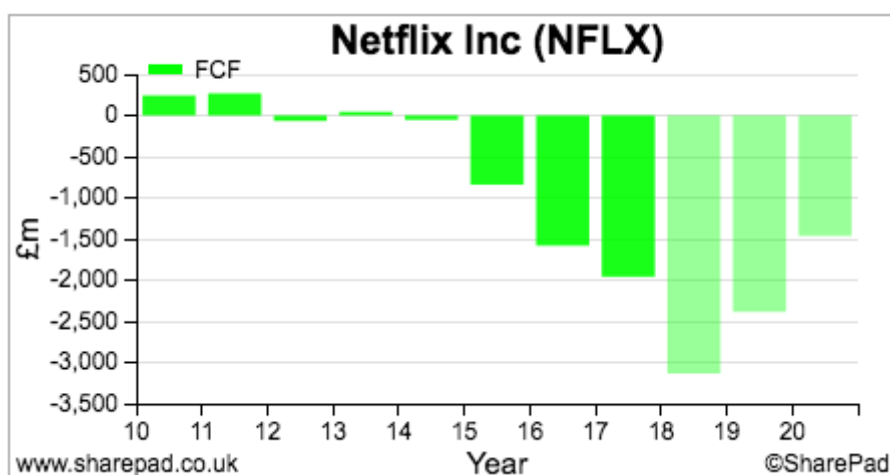
The company is also facing up to competition from Amazon and even Apple as they see media content as a way of holding on to and growing their customer base.

For all I know, Netflix's value could increase significantly from here. However, from the point of view of its finances, there are two characteristics that require very close attention based on its current and forecast financial performance.

FORECASTS		\$ millions unless stated				
Year	2018		2019		2020	
Turnover	16,103.9	+37.7%	19,947.7	+23.9%	24,385.0	+22.2%
EBITDA	2,089.4	-70.4%	3,208.5	+53.6%	4,860.7	+51.5%
EBIT	1,788.5	+147.2%	2,844.2	+59.0%	4,320.2	+51.9%
Pre-tax profit	1,367.2	+181.7%	2,425.1	+77.4%	3,841.0	+58.4%
Post-tax profit	1,319.6	+136.1%	2,104.5	+59.5%	3,265.6	+55.2%
EPS (¢)	288.8	+131.0%	468.4	+62.2%	711.7	+51.9%
Dividend (¢)	-		-		-	
CAPEX	183.9	+6.1%	211.5	+15.0%	251.1	+18.7%
Free cash flow	-3,134.3		-2,384.9		-1,463.6	
Net borrowing	6,656.9	+81.1%	8,787.5	+32.0%	10,043.4	+14.3%
NAV	-		-		-	
Like for like sales growth %	-		-		-	

The first thing is that the company's heavy investment is resulting in it having substantially negative free cash flows.

Netflix said this week that it expected to have negative free cash flow of \$3-4bn in 2018 as it builds its content library. It also said that it expected free cash flow to remain negative for several more years afterwards. Based on the chart above, it looks as if consensus estimates of this negative free cash flow might



need to be revised higher and could push towards the upper end of the guided range.

The second is that these free cash outflows mean that Netflix's net borrowings are also forecast to grow rapidly from \$6.6bn in 2018 to over \$10bn by 2020. Is there a danger that its debts could get too big relative to its cash flows?

Credit rating agencies will look at company indebtedness on measures such as net debt to EBITDA. On this measure, a number of over three times for a non-financial or non-utility company is beginning to look stretched and would be a cause for concern.

Netflix is forecast to exceed that number in 2018 and then reduce its level of indebtedness thereafter. If analysts' profit forecasts are right or are exceeded then debt is not a reason to be bearish on Netflix at the moment.

The bulls will argue that Netflix still has considerable pricing power. I agree. If I look at my own family's circumstances, we

pay £9.99 per month for 4k streaming and to be able to use four devices at once. Would we pay £15 per month if this was accompanied with more and better content? Possibly, yes.

This is why the pay TV operators are worried as even after a theoretical price hike, Netflix still looks cheap in the UK against a subscription from Sky or Virgin. Sky's Now TV streaming product is slightly cheaper than Netflix but does not have the range of content, simultaneous device allowances and picture quality (No HD or 4K) to compete. This may change if Disney ends up buying 21st Century Fox and Sky.

I'm not sure I could be persuaded to pay nearly 100 times rolling forecast profits for any share, but Netflix's business position and expected rapid profits growth is certainly attractive. However, sooner or later, Netflix has to start producing lots of free cash flow and no-one really has any idea when that will happen.

Netflix is certainly not a share I would be prepared to bet against by shorting it at the moment but a lot of future growth has clearly been priced in. The key threat I see is that third party content providers decide to go it alone with their own streaming and cut Netflix out of the loop.

