Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

03 May 2018

ShareScope and SharePad at Mello 2018

I just wanted to say a big thank you to everyone I met at the Mello 2018 investor conference in Derby last week. It was great to meet so many subscribers and hear your feedback on our products and services and learn what you like and what you would like us to do better.

Mello was without doubt the best private investor conference I have ever attended and I enjoyed it immensely. It was really good to be part of a community of people all trying to help each other. I know that ShareScope founder Martin Stamp and General Manager Tim Clarke who also attended the show really enjoyed it too. We all hope to be back at Mello in the future.

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7502.69	▲1.09	▲6.72	▲3.71	7778.64	6888.69	12/1/18	26/3/18
FTSE 250	20365.9	▲1.13	▲4.99	▲3.47	20932.6	19187.1	5/1/18	26/3/18
FTSE SmallCap	5889.48	▲0.843	▲4.98	▲6.34	6038.69	5527.03	15/1/18	4/5/17
FTSE AIM 100	5518.64	▲1.74	▲5.16	▲16	5550.39	4756.17	29/1/18	3/5/17
FTSE All-Share	4128.12	▲1.09	▲6.37	▲3.76	4268.89	3810.81	12/1/18	26/3/18
S&P 500	2599.4	▼-2.53	▼-0.576	▲8.85	2872.87	2357.03	26/1/18	17/5/17
Brent Oil Spot $	$73.22	▼-2.03	▲7.42	▲44.7	$75.035	$44.785	23/4/18	21/6/17
Gold Spot $ per oz	$1313.83	▼-0.32	▼-1.46	▲6.1	$1356.22	$1210.35	24/1/18	7/7/17
GBP/USD - US Dollar per British Pound	1.35495	▼-2.65	▼-3.69	▲5.26	1.43407	1.26325	16/4/18	20/6/17
GBP/EUR - Euros per British Pound	1.1331	▼-1.44	▼-1.12	▼-4.15	1.1898	1.0795	10/5/17	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	DTY	Dignity PLC	▲21.7
2	LUCE	Luceco PLC	▲18.8
3	WPP	WPP Group PLC	▲12.7
4	SBRY	Sainsbury (J) PLC	▲12.4
5	VM.	Virgin Money Holdings UK PLC	▲12.4
6	TCG	Thomas Cook Group PLC	▲11.7
7	STVG	STV Group PLC	▲11.4
8	ZPG	ZPG PLC	▲10.7
9	UAI	U and I Group PLC	▲9.62
10	EVR	Evraz PLC	▲9.03

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	HSTN	Hansteen Holdings PLC	▼-25.2
2	IRV	Interserve PLC	▼-20
3	GOG	Go-Ahead Group (The) PLC	▼-10.6
4	CNCT	Connect Group PLC	▼-10.5
5	MCB	McBride PLC	▼-8.65
6	KGF	Kingfisher PLC	▼-8.2
7	NOG	Nostrum Oil & Gas PLC	▼-8.01
8	AA.	AA PLC	▼-7.93
9	BWNG	Brown (N) Group PLC	▼-7.84
10	IWG	IWG PLC	▼-6.34

Sainsbury's (LSE:SBRY)

Share price: 305p

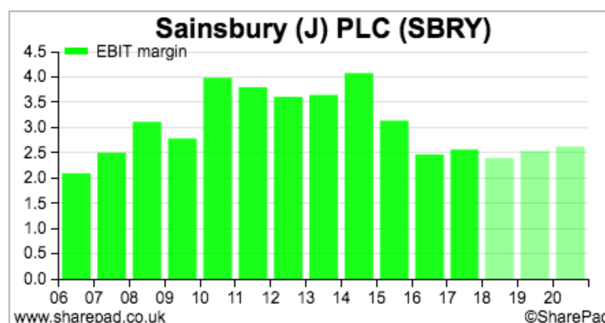
Mkt Cap: £6.9bn

EMS: 7,500

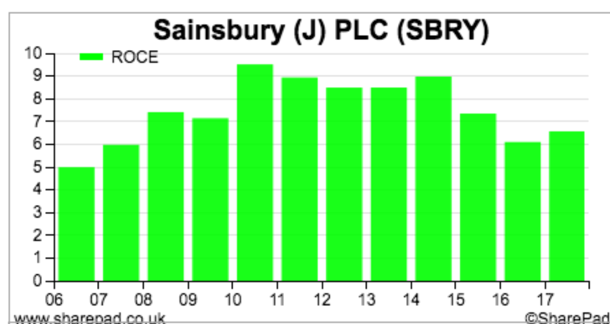
Analysts: 3

Sainsbury's does not come anywhere close to meeting my criteria for a good business investment despite the Oakley family buying its weekly groceries there. It operates in a fiercely competitive UK supermarket sector where it finds its prices out of kilter with many of its competitors.

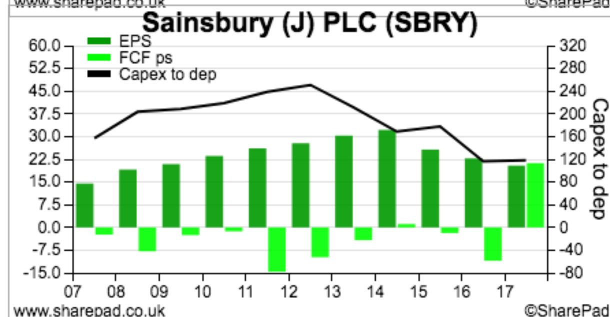
Its profit margins have been very low for years and have been falling despite over £1 billion of costs being taken out of the business over the last six years.



Operating a large network of very large supermarkets has made the business very asset intensive. Low profit margins have therefore fed through to very modest returns on capital employed (ROCE).



Generally speaking, Sainsbury's free cash flow performance has been awful and well below its underlying profit figure. Last year, saw an improvement in free cash flow due to a big working capital inflow from debtors and a reduction in supermarket capex. Skeleton results for the year to March 2018 released this week have seen a further improvement for similar reasons.



Sainsbury's has tried to reinvent itself by buying Argos and becoming a major player in general retailing but it doesn't look to have paid off so far. It has added extra sales but retail profits have gone nowhere over the last year.

The company is stuck in something of a rut. I think the quality of Sainsbury's food offer is very good and better than most of its competitors. The trouble is that it cannot convince lots of extra customers to shop in its stores or buy over the internet. It still has a reputation for being expensive that has been difficult to shake off and is finding it hard to woo shoppers from cheaper rivals.

£m	2017/18	2016/17	Change
Underlying results[1]			
Group sales (inc VAT)	31,735	29,112	9%
Retail operating profit	625	626	0%
Financial Services operating profit	69	62	11%
Underlying interest costs	119	119	0%
Profit before tax	589	581	1%
Underlying basic EPS	20.4p	21.8p	6%
Dividend per share	10.2p	10.2p	
Statutory results			
Items excluded from underlying results	(180)	(78)	
Profit before tax	409	503	

This has been reflected in its loss of market share over the last few years. The latest figures from Kantar WorldPanel show that Sainsbury's share of the UK grocery market fell from 16.2% a year ago to 15.9% currently.

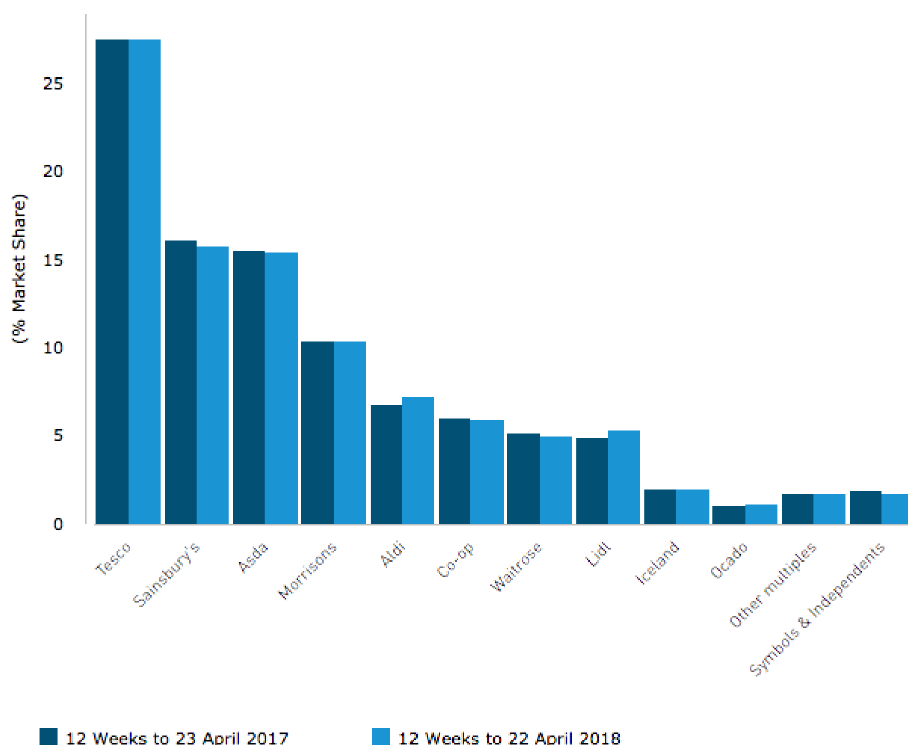
As a result of its troubles, Sainsbury's has announced an audacious plan to merge with another struggling food retailer, Asda. Although it has been called a merger, Sainsbury's is essentially buying Asda by issuing £4.3bn of new shares to its owner Walmart and paying another £3bn in cash. This will allow it to get its hands on Asda on a cash, debt and pension free basis.

Asda has problems of its own. Unlike Sainsbury's more upmarket offer, Asda has always pitched itself to customers as a low-priced supermarket. Its problem is that it hasn't been low priced enough and it has lost customers to discount retailers such as Aldi and Lidl. Asda currently has a market share of 15.5% compared with 15.6% a year ago according to Kantar.

But will the Competition and Markets Authority (CMA) allow the deal to go ahead?

Personally, I think that this is very unlikely without some concession such as store sales. A combined Sainsbury's/Asda would have 31.4% of the market and would be bigger than Tesco which has just over 27%. It would mean that two companies would control nearly 60% of the market. They will be hoping that the recent decision to allow Tesco to buy Booker will work in their favour but this could be wishful thinking.

Booker was essentially a food wholesaler with a very small convenience store business. Asda is a completely different kettle of fish. Other supermarkets and suppliers will be worried about the level of dominance and the lack of competition it will create.



The CMA will look at competition on a local basis. Asda is strong in the north of England whereas Sainsbury's is stronger in the south. If we look back to 2004 when Morrisons bought Safeway in a much smaller deal, store sales were a condition of the deal being approved. If the deal is not blocked, it is difficult to see how Sainsbury's will not be forced to sell a lot of stores.

Depending on how many stores end up being sold could change the economics of the deal. If the number is big, the benefits from improved buying power could be smaller than expected. The other issue is which competitor might end up owning those stores.

For example, a Sainsbury's or an Asda store might end up facing competition from a new Morrisons or Aldi or Lidl store in certain areas. Instead of having Sainsbury's and Asda not competing with each other, a rival could take customers from the store that is left and end up making the underlying financial performance of the business even worse.

The other key question about this proposed deal is why putting two struggling retailers together will lead to a better business. £500m of profit improvements are being targeted with £350m coming from better buying terms from suppliers. The remainder is expected to come from putting Argos into Asda stores and from other operational cost savings.

Yet there is little to explain how putting Sainsbury's and Asda together will lead to the formation of a better retailer that is capable of growing profits by selling more products. Sainsbury's talks about reducing prices by 10% on everyday items. This highlights the weakness of Sainsbury's current pricing but also requires an uplift in sales volumes for it to pay off.

It's difficult to see this as anything more than a cost-cutting exercise. It's by no means clear that Asda and Sainsbury's together can be bigger than the current sum of their parts.

But what would a combined Sainsbury's and Asda look like? I've had a go at a rough and ready approximation of what would happen to profit margins and ROCE from combining the two businesses.

To keep things simple, I've assumed that capital employed does not change in the first two years post-merger. Underlying sales growth is expected to be 1%, and underlying margins before cost and revenue benefits are assumed to be 3%. £230m of benefits are realised in the first year with £500m realised after the second year.

Financials (£m)	**SBRY**	**ASDA**	**Combined**	**Year 1**	**Year 2**
Revenue	28453	22200	50653	51160	51671
Operating profit	694	800	1494	1535	1550
operating margin	2.44%	3.60%	2.95%	3%	3%
Synergies				230	500
Post merger op profit				1765	2050
Post merger margin				**3.45%**	**3.97%**
Equity	6907				
Net debt	1858				
Other l-term liabilities	1536				
Capital Employed	**10301**	**7275**	**17576**	**17576**	**17576**
ROCE	**6.7%**	**11.0%**	**8.5%**	**10.0%**	**11.7%**

According to my estimates, ROCE would increase from 8.5% to 11.7% after two years. This is consistent with the expectations of management that ROCE would be a "low double-digit" number.

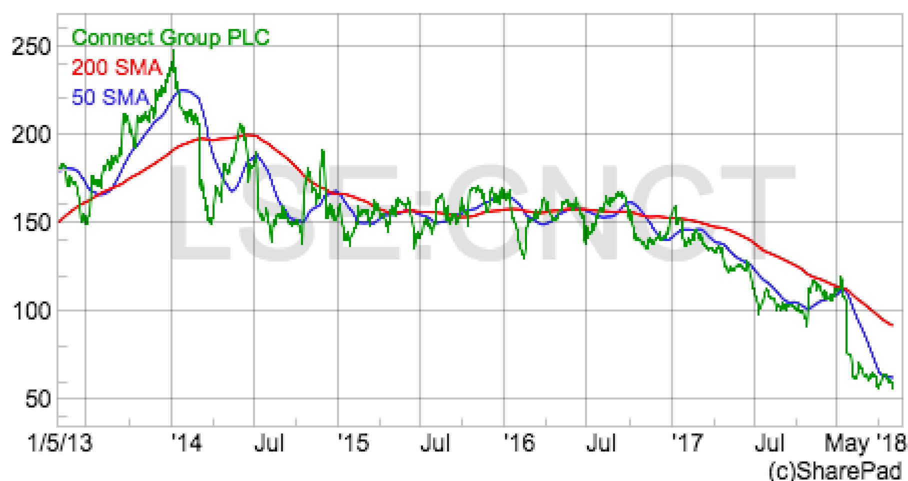
This is alright but nothing to write home about. The stock market seems to like the story though and has pushed up Sainsbury's share price from 269p last Friday to 313p at the time of writing.

This gives Sainsbury's a market capitalisation of £6.85bn or an enterprise value (EV) of £8.96bn based on current debt levels and the outstanding pension fund deficit. If we add on the £7.3bn sum to buy Asda, this gives a combined EV of £16.26bn or an EV/EBIT ratio of 7.9 times based on £2bn profits two years after the merger. This compares with Tesco on 11.4 times in two years' time.

It is interesting that the £16.3bn EV for the combined business is less than the value of its estimated capital employed. If a ROCE of 11.7% is sustainable then this would be above Sainsbury's cost of capital and therefore suggest that valuation could be a little harsh (note if companies can earn a ROCE above their cost of capital then their EV should be worth more than their capital employed).

However, that view is based on the premise that the deal goes ahead and we are a long way off from knowing if that will happen. On that basis, Sainsbury's share price might have got a little ahead of itself for now.

Connect Group (LSE:CNCT)



Share price: 54.5p

Mkt Cap: £140m

EMS: 10,000

Connect Group used to have a reputation as a reliable small cap dividend payer. Despite its core news distribution business continuing to decline year after year, an ability to keep making efficiency gains and good cash flows allowed its dividend to keep growing.

Where the company has gone wrong is that it has been unable to find a new source of income that has been capable of delivering reliable growth. It has made a number of acquisitions that have not worked out well.

It tried to move into the distribution of books and educational products but these businesses have been sold. The acquisitions of Tuffnells Parcels and a newly created delivery and returns business for online retailers are not doing well. As a result, the stock market is betting that Connect's dividend will have to be cut as evidenced by the current forecast dividend yield of 16.2%.

A look at this week's half year results shows a business that is struggling.

Smiths News	H117	H217	FY17	H118	TTM
Revenue	692.5	690.9	1383.4	666	1356.9
Operating profit	19.6	20.8	40.4	16.9	37.7
Operating margin	2.83%	3.01%	2.92%	2.54%	2.78%
DMD	**H117**	**H217**	**FY17**	**H118**	**TTM**
Revenue	14.2	14.6	28.8	13.4	28.0
Operating profit	1.1	1.2	2.3	1.3	2.5
Operating margin	7.75%	8.22%	7.99%	9.70%	8.93%
Tuffnells	**H117**	**H217**	**FY17**	**H118**	**TTM**
Revenue	86.6	96.6	183.2	88.1	184.7
Operating profit	4.3	7.7	12	-0.2	7.5
Operating margin	4.97%	7.97%	6.55%	-0.23%	4.06%

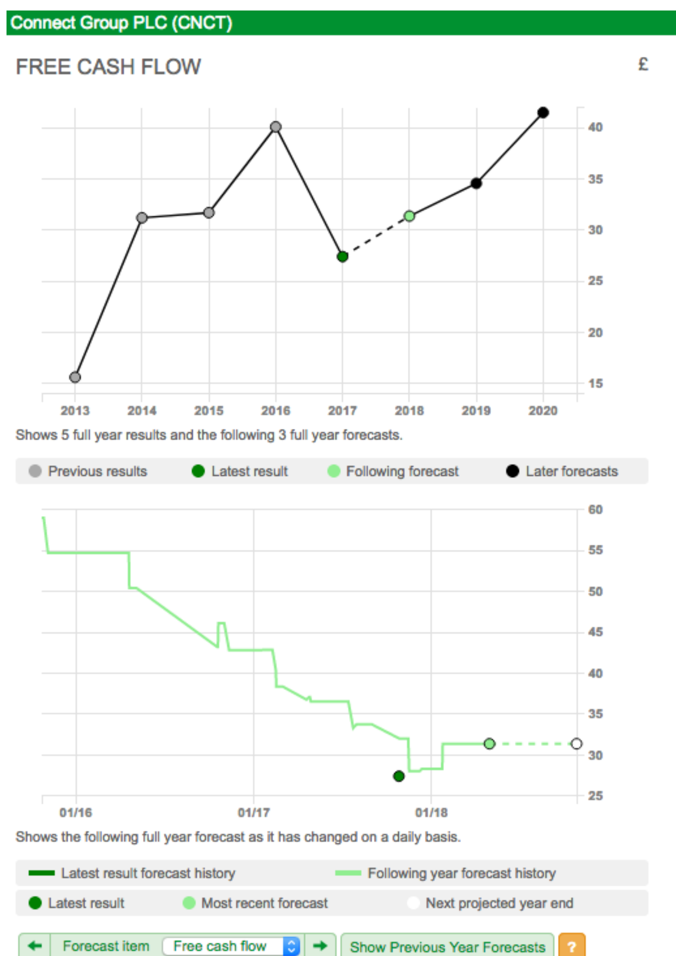
Apart from the very small DMD business which sells newspapers, magazines and inflight entertainment to airlines, profits are shrinking across the board.

Profits fell at Smiths News as cost cutting was insufficient to offset the continued decline in newspaper and magazine circulation. Profits should pick up in the second half of the year as sticker albums for the football World Cup are very profitable, whilst most of the £5m of annual cost savings targeted will also be realised.

The problems in Smiths News came from the Pass my Parcel business where despite strong demand for the service, incurred operating losses of £3.5m. This business does not look like it will be profitable any time soon and the management have concluded that it "cannot continue in its current form". It seems that the costs of coping with the volumes of returns is too high relative to the revenue it receives from customers such as Amazon. The balance sheet value of this business has been written down to zero.

Trading conditions at Tuffnells Parcels are worrying with the business moving into losses during the first half of the year. This business seems to be in a bit of a mess. The company refers to "increasing competition for customers and price sensitivity in the market" and that the revenue per consignment has fallen because of it.

Driver vacancies are also a problem and are feeding through to lower levels of customer service which could lead to customers going elsewhere. There has also been a high turnover of depot managers in key operational roles. This business looks like it is imploding internally with signs of very bad staff morale. This needs to be fixed quickly if profits are not to fall further.



Despite all the doom and gloom, the interim dividend was held at 3.1p per share, but can this be sustained? Underlying free cash flow during the period was £10m. In order to maintain a full year dividend of 9.7p per share, the company needs to generate £24m of free cash flow.

Current forecasts suggest that the company will do that but look at the chart below and see how significantly free cash flow forecasts have come down. A year ago, analysts were expecting free cash flow for 2018 to be nearly £60m. Now they are expecting nearly £31m. Given the current trends across the business, I can't help feeling that the forecasts of rising free cash flow are a bit bullish.

Connect shares have looked cheap for years and look very cheap now. At 56p, they trade on a rolling one-year forecast PE of just over four times. A current EV of around £220m is only 4.5 times expected operating profits.

Connect Group PLC (CNCT)

FORECASTS £ millions unless stated

Year	2018		2019		2020	
Turnover	1,549.8	-2.8%	1,501.8	-3.1%	1,447.3	-3.6%
EBITDA	65.6	-11.0%	65.8	+0.2%	69.3	+5.4%
EBIT	48.9	+18.3%	49.2	+0.8%	51.8	+5.2%
Pre-tax profit	42.3	+25.2%	42.8	+1.3%	45.0	+4.9%
Post-tax profit	35.0	+32.3%	35.5	+1.4%	36.6	+2.9%
EPS (p)	13.7	+28.0%	13.9	+1.5%	14.6	+5.0%
Dividend (p)	9.7	-1.0%	9.8	+1.0%	9.8	0.0%
CAPEX	15.0	-20.2%	14.8	-1.7%	13.7	-7.3%
Free cash flow	31.4	+14.5%	34.6	+10.2%	41.5	+20.1%
Net borrowing	82.0	-1.3%	77.7	-5.2%	73.5	-5.4%

There's not a lot to like about Connect's portfolio of businesses. They are either declining, loss-making or struggling with competition and operational difficulties. Therefore, they are not a collection of businesses that most people would want to own on a long-term view.

That said, I can't help thinking that a deep value investor might find the shares interesting at current levels. My fear would be that the Pass My Parcel losses could get bigger and profits decline further at Tufnells. The costs of closing or selling these would have to be taken into account. But is Connect really as cheap as it looks?

The key to answering this question is how much a declining news distribution business is potentially worth and would anyone want to buy it?

Valuing this business is not easy. Newspaper and magazine circulations are declining. How long before they stop being distributed and everything goes online?

The company seems to be able to take cost out but this does cost money to do. If we assume that free cash flows are equal to post tax operating profits and we discount those future free cash flows at a required return – or discount rate – of 10% and then assume that the business lasts for another 10 years we can come up with some valuations.

If we assumed the unlikely scenario that profits could be maintained at £40m per year, its value would be £208m.

News distribution	Op profit	Tax @19%	FCF	DF @10%	PV
H2 2018	23.6	-4.5	19.1	0.95	18.2
2019	40.0	-7.6	32.4	0.87	28.1
2020	40.0	-7.6	32.4	0.79	25.5
2021	40.0	-7.6	32.4	0.72	23.2
2022	40.0	-7.6	32.4	0.65	21.1
2023	40.0	-7.6	32.4	0.59	19.2
2024	40.0	-7.6	32.4	0.54	17.4
2025	40.0	-7.6	32.4	0.49	15.9
2026	40.0	-7.6	32.4	0.44	14.4
2027	40.0	-7.6	32.4	0.40	13.1
2028	40.0	-7.6	32.4	0.37	11.9
Estimated EV					**208.0**

Assuming that profits decline at 5% per year for 10 years gives a valuation of £173m

News distribution	Op profit	Tax @19%	FCF	DF @10%	PV
H2 2018	23.6	-4.5	19.1	0.95	18.2
2019	39.2	-7.4	31.8	0.87	27.5
2020	37.2	-7.1	30.2	0.79	23.8
2021	35.4	-6.7	28.7	0.72	20.5
2022	33.6	-6.4	27.2	0.65	17.7
2023	31.9	-6.1	25.9	0.59	15.3
2024	30.3	-5.8	24.6	0.54	13.2
2025	28.8	-5.5	23.3	0.49	11.4
2026	27.4	-5.2	22.2	0.44	9.9
2027	26.0	-4.9	21.1	0.40	8.5
2028	24.7	-4.7	20.0	0.37	7.4
Estimated EV					**173.5**

Both are below the current EV of £220m. DMD is worth something, but Pass my Parcels is probably not. I can't see many takers for Tuffnells but my guess it is certainly worth less than the £113m that Connect paid for it.

Based on my rough and ready reckoning, Connect shares might not be as cheap as they look. That said, further downside looks limited if management can stabilise profitability at Tuffnells and reduce losses – or exit the business entirely – at Pass My Parcel.

Avon Rubber (LSE:AVON)

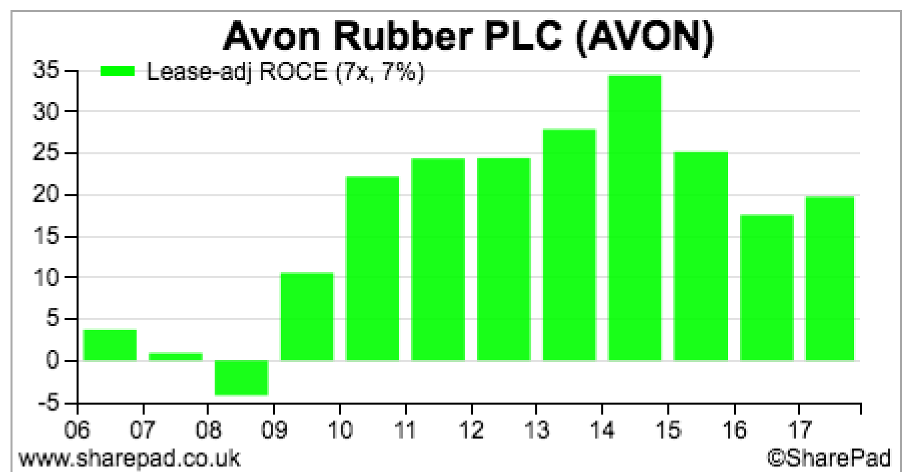
Share price: 1330p

Mkt Cap: £420m

EMS: 2,000

I think Avon Rubber is a very good business. It has carved out a profitable niche for itself in manufacturing and selling protective breathing systems to military, law enforcement and fire services. It also has a milking point solutions business selling products and services to dairy farmers.

Both businesses use technology to give them a competitive edge which enables them to earn high profit margins and for Avon as a whole to earn good returns on capital employed (ROCE).



Avon's business has been transformed over the last decade by contracts to supply the US military with protective masks. Its M50 mask was given a 10-year exclusive contract by the US Department of Defence (DoD) in 2008 which ends this year. There had been some concern from investors about what would happen to Avon's profits after it ended. The good news for its shareholders is that Avon seems to be doing well as evidenced by Wednesday's half year results.

70% of Avon's revenues come from the United States. Given that the value of the pound has strengthened by 9.5% against the US dollar compared with last year, Avon's revenue growth of 5.9% at constant exchange rates was a creditable result. At actual exchange rates, revenues actually fell by £1.2m to £77.7m. Adjusted operating profits increased by 6.4% to £11.6m.

Protection (£m)	2013	2014	2015	2016	H1 17	H2 17	2017	H118	TTM
Sales	93.1	92.8	98.8	100.9	53.7	60.1	113.8	53.1	113.2
Op Profit	16.1	13.6	15.9	15.1	8	11.8	19.8	9.2	21
Margin	**17.3%**	**14.7%**	**16.1%**	**15.0%**	**14.9%**	**19.6%**	**17.4%**	**17.3%**	**18.6%**

Dairy (£m)	2013	2014	2015	2016	H1 17	H2 17	2017	H1 18	TTM
Sales	31.7	32	35.5	42	25.2	24.2	49.4	24.6	48.8
Op Profit	5.2	5.7	6.4	7.2	4	4	8	3.6	7.6
Margin	**16.4%**	**17.8%**	**18.0%**	**17.1%**	**15.9%**	**16.5%**	**16.2%**	**14.6%**	**15.6%**

The dominant Protection business posted a decent performance with an increase in profit margins. Revenues from the DoD was lower due to lower shipments of M50 masks but orders in the second half of the year are set to pick up with new orders for M50 masks and a continued build up from the new MCM100 underwater rebreathers.

Sales to police forces in North America were up by 42% in constant currency terms whilst the Powered Air range of products is seeing orders build up nicely. Sales to Fire departments were down slightly as market conditions in North America were a little tougher.

The Dairy business was slightly disappointing in my opinion. Profits were up by 2.3% on a constant currency basis but were held back by the strength of the pound and weakness in North America where increases in animal feed costs has cut demand for milking equipment. The focus on cost control in the second half of the year suggests that trading conditions are set to stay tough.

Research & Development (£m)	H117	H217	FY17	H118	TTM
Money spent	3.9	4.5	8.4	4.4	8.9
less customer funded	-2	-2.6	-4.6	-1.4	-4
Net money spent	**1.9**	**1.9**	**3.8**	**3**	**4.9**
Capitalised on balance sheet	-0.9	-1.8	-2.7	-2.6	-4.4
Expensed in income statement	1	0.1	1.1	0.4	0.5
Amortisation in income statement	2	1.5	3.5	1.3	2.8
Total expense charged to income statement	**3**	**1.6**	**4.6**	**1.7**	**3.3**
Difference between expense and cash spent	-1.1	0.3	-0.8	1.3	1.6

Avon continues to spend a decent amount of money (5.7% of sales) on researching and developing new products (R&D). The company does capitalise some of this expenditure rather than fully expensing against revenues in the income statement. This has the potential to have an impact on profits and growth rates.

During the first half of 2018, £4.4m was spent of which £1.4m was funded by customers. Of the £3m spent by Avon, £2.6m went on the balance sheet with £0.4m expensed in the income statement. A further £1.3m of previously capitalised expenditure was amortised through the income statement. So the expense through the income statement - £1.7m - was £1.3m less than the cash spent.

The income statement expense was also £1.3m lower than a year ago. Considering that adjusted operating profits only increased by £0.7m in total you can see that this lower R&D expense was helpful in achieving that result. If exchange rates are ignored, constant currency operating profit growth of 18.9% equates to a £1.8m increase which highlights that this R&D factor was significant.

Avon's finances are in very good shape. Operating cash flow increased by 12.2% to £19.2m whereas higher capex saw free cash flow fall from £13.4m to £12.2m. Proceeds from disposals help bump up the net cash balance to a very healthy £39.1m which the company mentioned that it might spend on buying companies.

The company had previously mentioned its intention to pay out a greater proportion of its profits in dividends to shareholders. This has resulted in a 30% increase in the interim dividend per share to 5.34p. Similar rates of growth are expected for the next couple of years.

The outlook statement probably disappointed some investors who were hoping for something that would cause analysts to increase their profit forecasts. The closing order book was nearly 18% higher than a year ago but it seems that currency headwinds will see this help the company meet rather than beat current forecasts at the moment.

"We have delivered strong financial results, with underlying performance more than offsetting currency headwinds, whilst continuing to build the order book. We have also made further progress on the longer-term growth opportunities for our expanding product portfolio.

The performance reflects the benefits of the strategic actions being implemented to enable the Group to continue to grow sustainably in our core markets. Building on this platform, and with the momentum from our expanding product portfolio, ***the Board remains confident on delivery of its current year expectations and is excited by the medium-term prospects for the Group."***

Avon Rubber PLC (AVON)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	163.8	+0.4%	169.1	+3.2%	174.3	+3.1%
EBITDA	37.0	+4.0%	38.0	+2.7%	39.5	+3.8%
EBIT	26.2	+17.0%	27.3	+4.1%	29.2	+6.8%
Pre-tax profit	26.7	+25.8%	27.8	+4.1%	29.1	+4.9%
Post-tax profit	22.2	-8.0%	22.0	-0.9%	22.4	+2.1%
EPS (p)	71.9	-8.6%	72.8	+1.3%	76.0	+4.4%
Dividend (p)	15.7	+27.4%	19.8	+26.1%	21.2	+7.1%
CAPEX	4.8	-13.6%	4.8	0.0%	4.8	0.0%
Free cash flow	20.6	-23.6%	19.6	-5.2%	21.8	+11.6%
Net borrowing	-43.7		-59.9		-69.4	
NAV	69.1	+24.2%	81.3	+17.7%	-	

I like Avon as a business but feel the valuation of its shares is probably about right at the moment given the absence of forecast upgrades. At 1330p, they trade on a one year forecast rolling PE of 18.8 times or 16.6 times if the net cash balance is adjusted for. That's not really expensive but I feel the shares may pause for breath for a while after a good run.