Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

10 May 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7700.97	▲2.64	▲5.98	▲4.28	7778.64	6888.69	12/1/18	26/3/18
FTSE 250	20699.4	▲1.64	▲5.2	▲4.14	20932.6	19187.1	5/1/18	26/3/18
FTSE SmallCap	5965.74	▲1.29	▲5.09	▲6.12	6038.69	5551.56	15/1/18	4/4/18
FTSE AIM 100	5616.3	▲1.77	▲5.2	▲16.7	5616.3	4768.33	10/5/18	6/7/17
FTSE All-Share	4228.42	▲2.43	▲5.82	▲4.33	4268.89	3810.81	12/1/18	26/3/18
S&P 500	2716.34	▲3.29	▲2.24	▲13.2	2872.87	2357.03	26/1/18	17/5/17
Brent Oil Spot $	$77.035	▲4.55	▲8.45	▲53.2	$77.365	$44.785	9/5/18	21/6/17
Gold Spot $ per oz	$1318.49	▲0.422	▼-1.74	▲8.27	$1356.22	$1210.35	24/1/18	7/7/17
GBP/USD - US Dollar per British Pound	1.34931	▼-0.58	▼-4.85	▲4.36	1.43407	1.26325	16/4/18	20/6/17
GBP/EUR - Euros per British Pound	1.13425	▲0.199	▼-1.12	▼-4.67	1.1898	1.0795	10/5/17	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	RHIM	RHI Magnesita NV	▲19.3
2	RSW	Renishaw PLC	▲17.5
3	DIA	Dialight PLC	▲12.3
4	OXB	Oxford BioMedica PLC	▲11.8
5	NANO	Nanoco Group PLC	▲11.3
6	PSON	Pearson PLC	▲10.9
7	PDL	Petra Diamonds Ltd	▲10.1
8	PMO	Premier Oil PLC	▲9.65
9	MGP	Medica Group PLC	▲9.4
10	KMR	Kenmare Resources PLC	▲9.09

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	LUCE	Luceco PLC	▼-16.9
2	SDRY	Superdry PLC	▼-16.3
3	LMI	Lonmin PLC	▼-16.2
4	GRG	Greggs PLC	▼-13.5
5	IRV	Interserve PLC	▼-13.5
6	ARW	Arrow Global Group PLC	▼-12.6
7	OTB	On The Beach Group PLC	▼-12
8	DEB	Debenhams PLC	▼-11.3
9	ALM	Allied Minds PLC	▼-8.56
10	FGP	FirstGroup PLC	▼-7.71

Treatt (LSE:TET)

Treatt is a good business. The company specialises in making and selling products based on essential oils. It takes natural plant oils such as orange, lime, peppermint and eucalyptus and uses them to create flavours and fragrances to sell to consumer goods companies.

In recent years Treatt has tapped in to the growing market for citrus flavourings, natural teas and lower sugar content and has seen it sales and profits rise as a result. As most of its sales come from overseas markets, the company also benefitted from the weakness in the value of the pound after the EU referendum which made its products cheaper in foreign currencies.

However, a sharp rise in its share price from the beginning of 2016 until the middle of 2017 came to abrupt halt last year as investors began to worry that it could not sustain its profits growth and that a weak currency had flattered results. This week's half year results put those worries firmly to bed.

Revenues increased by a very healthy 13.7%, driven by very strong growth in the UK (+44.7%) and the USA (+14.2%). Across its key product lines, sugar reduction products saw revenue increases of 15.4%, tea 38.5% and citrus 10.3%. Treatt is selling more to existing customers as well as winning new business. The company highlighted that it was doing very well in selling natural fruit and vegetable extracts to premium drinks companies.

Operating profit margins increased from 11% to 11.3%. The company received a big boost from lower tax rates in the USA which saw its underlying tax rate fall from 28.4% to 17.3%. As a result, underlying EPS increased by 30.1% to 8.34p.

Treatt's revenue growth continues to require a significant amount of working capital support in the form of trade debtors (selling on credit) which has resulted in last year's poor operating cash flow conversion continuing.

	Six months to 31 March 2018 (unaudited) £'000	Six months to 31 March 2017 (unaudited) £'000
Cash flow from operating activities		
Profit before taxation including discontinued operations	6,218	5,493
Adjusted for:		
Depreciation of property, plant and equipment	758	709
Amortisation of intangible assets	68	71
Loss on disposal of property, plant and equipment	-	13
Loss on disposal of intangible assets	31	-
Net finance costs	344	420
Share-based payments	547	467
Decrease/(increase) in fair value of derivatives	137	(22)
Increase/(decrease) in post-employment benefit obligations	57	(55)
Operating cash flow before movements in working capital	8,160	7,096
Movements in working capital:		
Increase in inventories	(1,520)	(10,061)
Increase in trade and other receivables	(7,374)	(2,908)
Increase in trade and other payables, and provisions	2,157	5,811
Cash generated from operations	1,423	(62)

In some companies, this can be a sign of aggressive accounting or over trading but I don't think that there are grounds for concern with Treatt. The company offers a very reassuring explanation in its press release:

"*During the period there was a net working capital outflow of £6.7m which largely related to an increase in trade and other receivables of £7.4m* ***as the period ended strongly. This is expected to unwind in H2*** *as there has not been any material change in the average days sales outstanding.*"

Given strong first half results, and the fact that trading remains strong, I think there is a good chance that profit forecasts for the year ending September 2018 will increase.

I always find it useful to calculate the trailing twelve-month profits from a set of half year results and compare them with current consensus forecasts to see if the company is on track to meet or beat them.

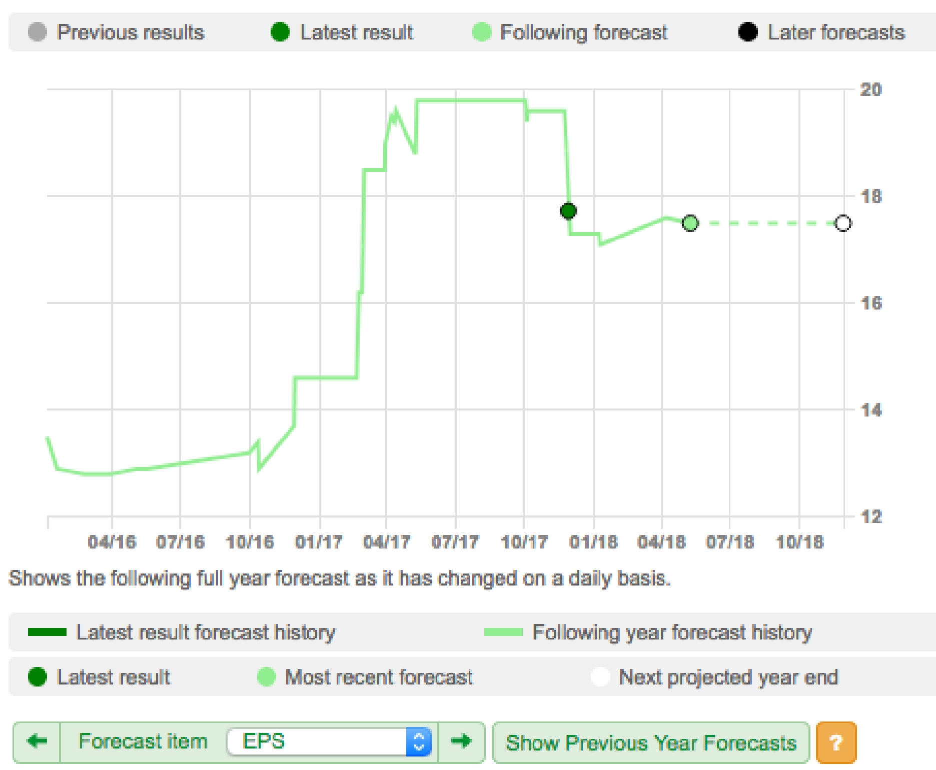
Treatt (£m)	H117	H217	FY17	H118	TTM
Revenues	47.1	62.5	109.6	53.6	116.1
Operating Profit	5.2	8.6	13.8	6.1	14.7
Pre-tax profit	**4.8**	**8.1**	**12.9**	**5.8**	**13.9**

Trailing twelve months pre-tax profit is currently £13.9m compared with the current forecast of £13.3m. This contains £0.66m from the Earthoil Plantations business that will be sold on 31st May 2018. This business contributed £1.18m in PTP last year, but even losing around an estimated £0.3m during the second half of the year from this business, it seems that Treatt is on track to beat the current consensus forecast.

Treatt PLC (TET)

FORECASTS £ millions unless stated

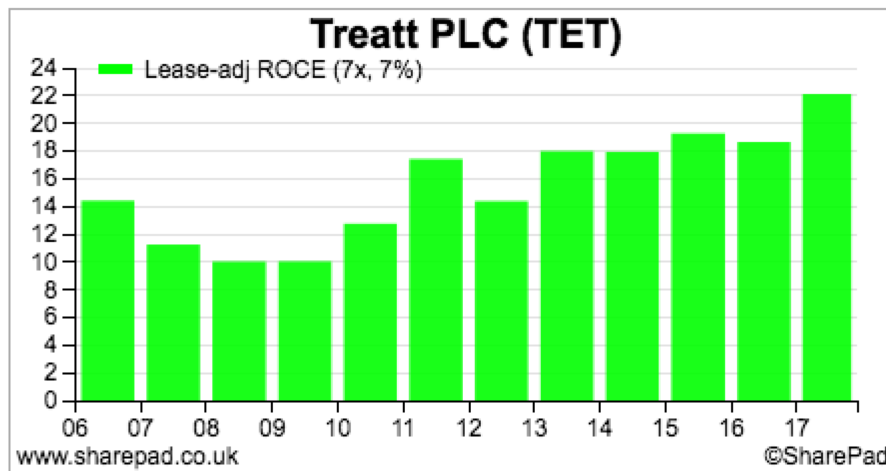
Year	2018		2019		2020	
Turnover	116.8	+6.5%	122.3	+4.7%	127.8	+4.5%
EBITDA	16.5	+7.6%	18.9	+14.3%	20.8	+10.2%
EBIT	14.1	+2.4%	15.4	+9.0%	16.2	+5.1%
Pre-tax profit	13.3	+2.9%	14.1	+6.1%	15.0	+6.7%
Post-tax profit	10.1	+5.5%	10.7	+5.8%	11.4	+6.7%
EPS (p)	17.5	-1.3%	18.3	+4.6%	19.5	+6.6%
Dividend (p)	4.9	+2.1%	5.2	+6.1%	5.4	+3.8%
CAPEX	25.8	+393.9%	23.8	-7.4%	2.7	-88.6%
Free cash flow	8.2		8.6	+4.9%	10.2	+18.6%
Net borrowing	2.7	-73.3%	15.5	+469.3%	6.2	-59.8%
NAV	75.9	+63.2%	85.0	+12.0%	94.6	+11.4%



Shows the following full year forecast as it has changed on a daily basis.

When I wrote about Treatt back in November last year, I questioned whether Treatt's very impressive ROCE was being flattered by very old assets. The company is moving to a new site in Bury St Edmunds at a cost of £35m and is expected to move in at the end of 2019. This will add lots of extra capacity to help the company grow its revenues but it will lead to a significant increase in capital employed.

My concern was that Treatt's operating profits would grow more slowly than its capital employed and that ROCE would fall as a result.



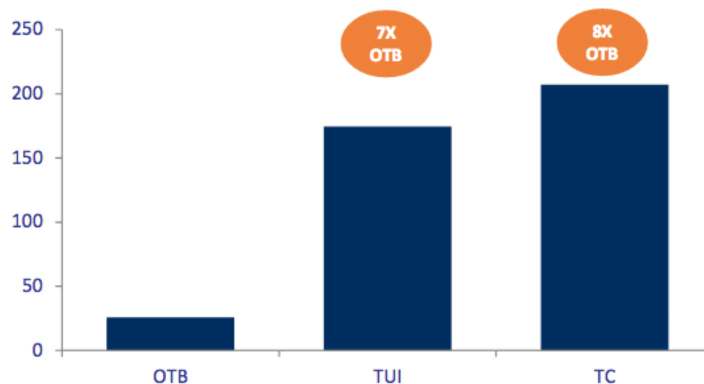
This seems to have been confirmed by Treatt in this week's results as the targetted return on investment is 10-15% over the medium term.

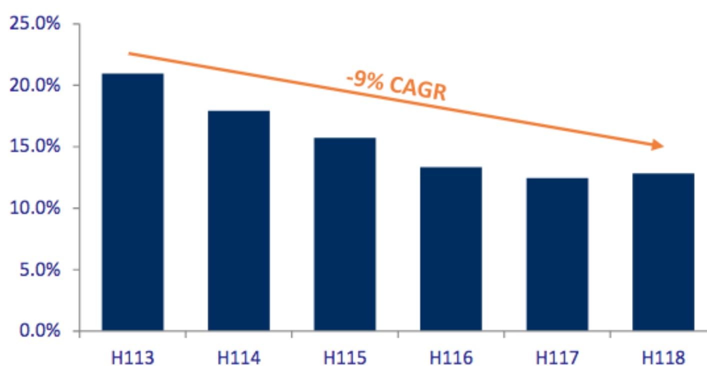
I like Treatt as a business but at 481p I think its shares are quite expensive on a one year forecast rolling PE of 27.4 times. This PE multiple will come down if my view on forecast upgrades is right but the spike in the share price over the last three weeks seems to be pricing in a fairly rosy outlook already.

On The Beach (LSE:OTB)

On the Beach (OTB) is a beach holiday business. It has over 20% share of the online short haul beach holiday market in the UK. Its aim is to use its technology and low-cost base to take customers away from traditional travel agents and tour operators.

As you can see from the slide below, OTB has a much lower cost base per booking than traditional tour operators such as TUI and Thomas Cook. As OTB has grown, its fixed and variable costs as a percentage of revenue have come down. This is part of its competitive edge.





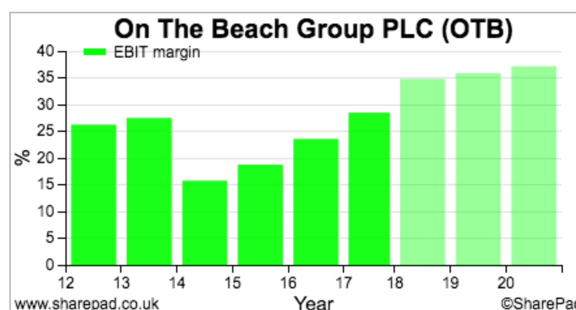
OTB should have lower costs as it does not own or lease planes and hotels and does not have the costs of running high street travel agencies. Its costs are dominated by online marketing along with staff costs and website development costs.

OTB is essentially a middleman. It books flights and hotels for its customers and gets paid commissions by airline and hotel owners in return.

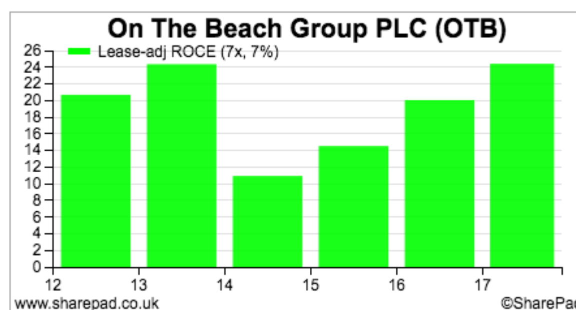
The company has grown rapidly in recent years. Revenues have grown from £31m in 2012 to £83m in 2017. Over the same period, operating profits have grown from £8m to £23m.

OTB stacks up well on many financial measures:

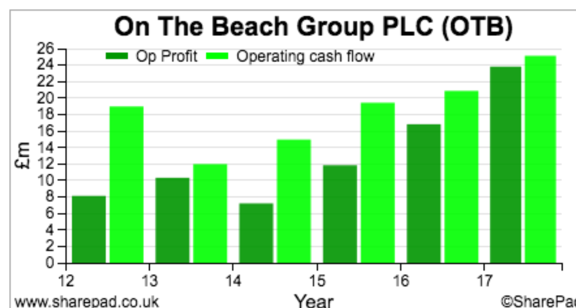
It has very high profit margins:



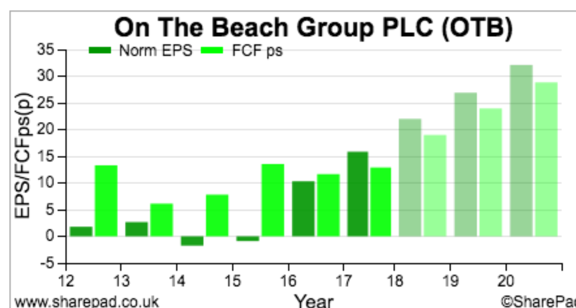
It has very impressive returns on capital employed (ROCE) due to its very asset light business model – it does not own any aeroplanes or hotels.



It also passes a key profit quality test of being good at turning its profits into cash flow.



Conversion of earnings per share into free cash flow per share is also pretty respectable.



Given these characteristics combined with growth it's not too difficult to see why the shares have done well since listing on the stock exchange in 2015.

Half year results looked to be fairly solid but no more than that. Revenues increased by 19% to £45.3m with operating profits after deducting share-based payments (the company does not do this) increasing by 9% to £13.2m. The decline in operating margin from 31.7% to 29.1% can be explained by three factors:

- Increased losses at the International business.
- The integration of the acquired Sunshine brand which has lower margins.
- A £1.1m hit from the fallout of the Monarch Airlines bankruptcy. This created a reduction in available airline seats and pushed up ticket prices. As a result, this depressed demand for holidays over the winter. This problem should not recur as additional airline capacity has entered the market.

The company remains upbeat about growing its revenues and improving profit margins by more direct sourcing of hotel rooms. That said, its outlook statement will have disappointed some investors as it was only expected to meet current profit forecasts not beat them:

"*Given the resilient and flexible nature of our business model,* ***the Board remains confident in delivering a full year result in line with management's expectations,*** *taking into account the one-off impact of flight capacity constraints as a result of the Monarch failure and the accelerated investment to support international growth.*"

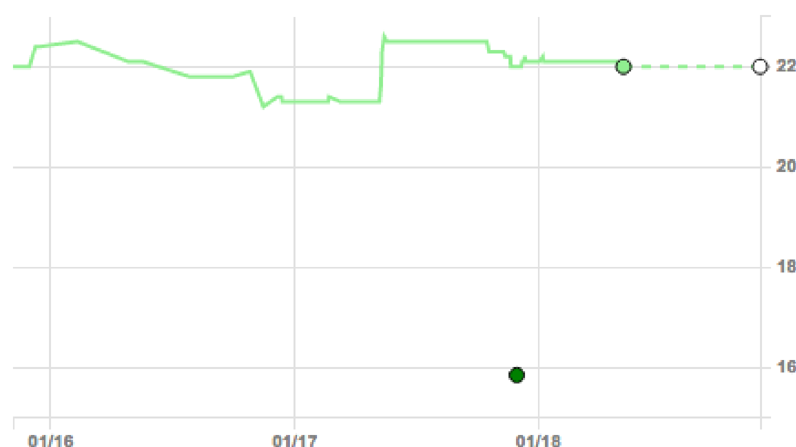
The shares are currently down 12% at the time of writing at 571p. Based on a one year forecast rolling EPS of 25p, this puts the shares on a one year forecast rolling PE of 22.8 times. However, it's possible that current expectations of profit margin increases may have to be moderated in the short term which could see a slight downgrade to current forecasts

On The Beach Group PLC (OTB)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	102.7	+22.9%	119.3	+16.2%	135.7	+13.8%
EBITDA	38.6	+25.8%	47.1	+22.1%	55.8	+18.3%
EBIT	35.7	+50.0%	42.8	+19.7%	50.4	+17.9%
Pre-tax profit	35.4	+49.2%	43.4	+22.4%	51.7	+19.3%
Post-tax profit	28.6	+38.6%	34.9	+21.8%	40.8	+17.0%
EPS (p)	22.0	+38.8%	26.9	+22.3%	32.1	+19.3%
Dividend (p)	3.6	+28.6%	4.7	+30.6%	5.7	+21.3%
CAPEX	1.5	-52.0%	1.8	+20.0%	3.9	+116.7%
Free cash flow	24.8	+47.3%	31.2	+26.1%	37.6	+20.4%
Net borrowing	-50.5		-77.5		-109.0	

Previous results · Latest result · Following forecast · Later forecasts



Shows the following full year forecast as it has changed on a daily basis.

Latest result forecast history · Following year forecast history

Latest result · Most recent forecast · Next projected year end

Forecast item EPS · Show Previous Year Forecasts · ?

Given forecast EPS growth rates of more than 20% for the next few years, I can understand why some people might view the shares as being attractively valued on the back of this price fall. That said, OTB is not a business that grabs me as a customer.

I ventured onto its website and looked at the cost of taking my family on a short break to Benidorm during the late May half-term holiday for four nights. It gave me a price of easyJet flights and a hotel. The total cost was barely any different from booking directly with easyJet and the same hotel on booking.com - in fact the hotel room was better going direct.

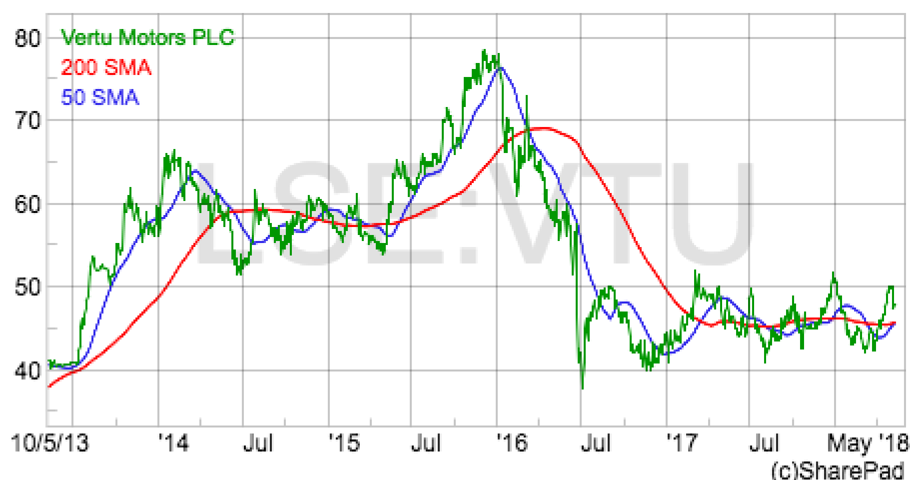
This is only an isolated example but I could not see any benefit from using OTB – or any other travel agent for that matter – compared with doing the job myself. However, I do accept that maybe I am in a minority here.

That said, there is no doubt that the company has done a very good job building up its business. It has put a lot of time and money into building up its website technology and brand through very impressive marketing strategies.

This is not easy or cheap for a new entrant to copy. That's not to say that an existing online travel agent could not change its business model to compete with OTB.

OTB has a relatively simple and flexible business model compared with traditional tour operators and is continuing to build up its relationships with airlines and hotels. I think this is a business that should be able to keep on growing nicely but I'd be wary of possible responses from competitors.

Vertu Motors (LSE:VTU)



Up until 2017, the country's car dealerships had enjoyed a good few years of making more money. Cheap finance provided by manufacturers led to a boom in new car sales in the UK. Vertu Motors benefited from this trend and added to it by hoovering up other car dealerships. From a standing start in 2007, it is now the sixth biggest franchised car dealership in the UK with 117 dealerships.

The new car boom has now petered out and this has made life tougher for car dealerships which are dependent on volume bonuses from manufacturers to make money from selling new cars. In order to keep profits at a reasonable level, the onus is on them to grow sales from more profitable activities such as selling used cars and aftersales activities including servicing and repairs.

For the year ending February 2018, Vertu managed to post a creditable financial performance in difficult markets. Revenues and profits were broadly flat.

A look at the table below shows how profitable aftersales are compared with selling new cars – the gross margins are significantly higher. Aftersales and used cars accounted for 46% of Vertu's

Year ended 28 February 2018

	Revenue £'m	Revenue Mix %	Gross Margin £'m	Gross Margin Mix %	Gross Margin %
Aftersales[1]	228.2	8.2	124.7	40.4	44.5
Used cars	1,068.9	38.2	98.7	31.9	9.2
New car retail and Motability	836.5	29.9	64.1	20.8	7.7
New fleet and commercial	662.5	23.7	21.4	6.9	3.2
	2,796.1	**100.0**	**308.9**	**100.0**	**11.0**

Year ended 28 February 2017

	Revenue £'m	Revenue Mix %	Gross Margin £'m	Gross Margin Mix %	Gross Margin %
Aftersales[1]	227.0	8.0	123.4	39.4	44.6
Used cars	1,037.5	36.8	100.7	32.1	9.7
New car retail and Motability	909.4	32.2	68.3	21.8	7.5
New fleet and commercial	648.7	23.0	21.1	6.7	3.3
	2,822.6	**100.0**	**313.5**	**100.0**	**11.1**

1. margin in aftersales expressed on internal and external revenue.

total sales in 2017 but 72% of its gross profits. Vertu's task is to get these profit streams to grow as they did not do so in aggregate last year.

The company talks optimistically about how the increased technology in today's cars is helping to keep customers tied to franchised dealerships for servicing. This tends to be the case whilst the cars are under three years old or part of a finance plan (personal contract plan or PCP for short), the task is to keep customers with older cars coming back to the main dealer network.

The table below shows why I use a specialist independent servicing business for my car as I find the main dealer prices to be nothing short of a rip off. Vertu is making gross profit margins of more than 76% on servicing and I can understand why. I recently had my one-year old Audi A3 serviced for £129 at an independent VW/Audi specialist (they had all the necessary equipment and digital servicing); the price at the franchised dealer was £289.

As with online travel agencies above, I admit that I might not be a typical customer. If Vertu can get more customers into its workshops then the outlook for its profits will be reasonably good in my view.

	2018 £'m	2017 £'m	Growth
Service revenue	102.8	98.2	4.7%
Parts and accident repair revenue	145.8	143.8	1.4%
Like-for-like aftersales revenue	**248.6**	**242.0**	**2.7%**
Service gross margin	76.4%	77.3%	
Parts and accident repair gross margin	23.0%	23.1%	
Like-for-like aftersales gross margin	**45.1%**	**45.1%**	

Selling used vehicles is more profitable than selling new ones but Vertu's sales fell slightly last year. The company has a lot of premium car franchises where manufacturers have increased their supply of nearly new cars as well as offering a lot of very competitively priced new cars. This has pushed down prices on used cars and diluted profit margins.

The key to success in selling used cars is turning over the stock of them as quickly as possible. Used cars that sit on a dealer forecourt for too long are a depreciating asset and can burn a big hole in the dealer's profit margins if stocks are not managed well.

Vertu has increased its stock of used vehicles to compensate for lower part exchange volumes from lower new car sales. This is shown on its balance sheet below.

CONSOLIDATED BALANCE SHEET (AUDITED)
As at 28 February 2018

	2018 £'000	2017 £'000
Non-current assets		
Goodwill and other indefinite life assets	94,381	94,595
Other intangible assets	1,316	1,518
Retirement benefit asset	6,551	1,884
Property, plant and equipment	198,004	197,545
Total non-current assets	**300,252**	**295,542**
Current assets		
Inventories	558,386	506,470
Trade and other receivables	66,272	52,545
Cash and cash equivalents	41,709	39,845
	666,367	598,860
Property assets held for sale	2,449	-
Total current assets	**668,816**	**598,860**
Total assets	**969,068**	**894,402**
Current liabilities		
Trade and other payables	(663,404)	(610,317)
Deferred consideration	-	(1,572)
Current tax liabilities	(3,304)	(3,840)
Borrowings	(12,811)	(8,671)
Total current liabilities	**(679,519)**	**(624,400)**

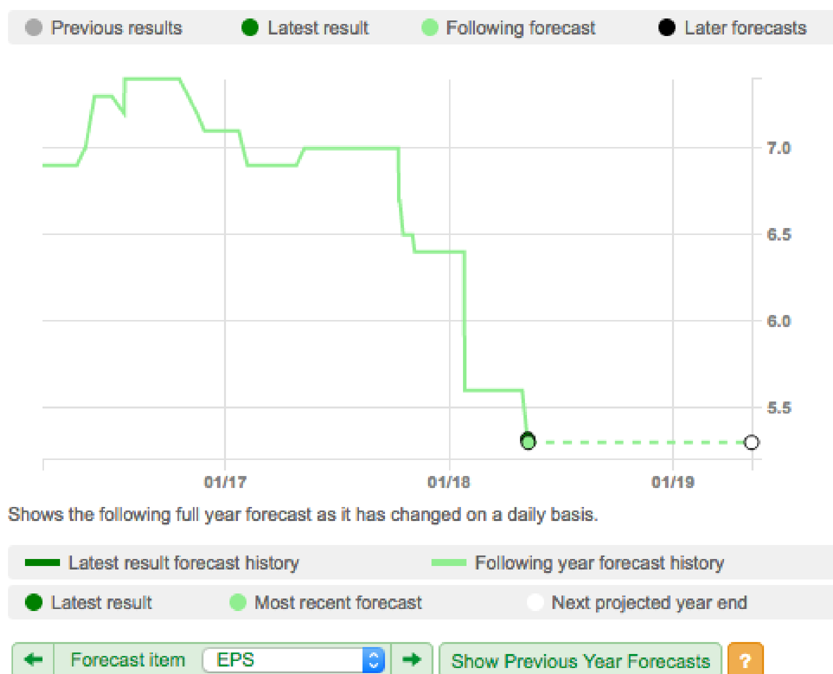
Closing inventories as a percentage of turnover increased from 18% to 20% last year. This could be a worrying development, but the new year has started well with used car sales up 7% during the first two months of the new financial year with the outlook for the rest of the year favourable according to the company.

Vertu Motors PLC (VTU)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	2,806.6	+0.4%	2,815.0	+0.3%	2,875.5	+2.1%
EBITDA	34.9		40.9	+17.0%	40.1	-1.8%
EBIT	27.7		31.4	+13.4%	32.3	+2.9%
Pre-tax profit	26.0	-14.7%	29.4	+13.1%	30.4	+3.5%
Post-tax profit	-		-		-	
EPS (p)	5.3	-0.4%	6.0	+13.2%	6.2	+3.3%
Dividend (p)	1.6	+6.7%	1.7	+6.3%	1.9	+11.8%
CAPEX	31.5		15.3	-51.6%	15.5	+1.6%
Free cash flow	-2.4		17.2		14.6	-15.1%
Net borrowing	-11.1		-21.4		-32.6	
NAV	276.4		291.5	+5.5%	307.1	+5.4%

That said, analysts are expecting a year of falling profits in 2019. The other thing to keep an eye on is free cash flow. Working capital has been eating up trading cash flow whilst capex spending has been quite high as manufacturers have forced dealerships to upgrade their premises. Free cash flow was negative last year and is expected to be so again in 2019 before capex spending reduces in 2020.



Car dealerships are low margin, cyclical businesses and therefore should not see their shares trade on high multiples of profits in my opinion.

Name	Close	Market Cap. (m)	PE roll 1	Enterprise value / fc Norm EBIT	fc Yield	fc Dividend cover
Vertu Motors PLC	47.35p	£180.7	8.7	6.5242	3.4	3.3

This is the case for Vertu. One interesting valuation aspect is the asset backing that dealerships have in the form of their dealership properties and used vehicle stock. Vertu has been realising profits on the disposal of its unwanted dealerships which is an indication that their balance sheet values are believable.

Vertu's net tangible asset value per share at the end of February was 44.2p which is just below the current share price and provides some support to it in my view.

I also expect the company to use its ungeared balance sheet (net cash of £19.3m) to buy other dealerships in a market that is expected to consolidate over the next few years.

Car dealerships would not be my first place to invest money, but short of a collapse in the car market I can see how the sector might attract patient value investors.