Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

25 May 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7716.74	▼-0.915	▲3.92	▲2.69	7877.45	6888.69	22/5/18	26/3/18
FTSE 250	20989.5	▼-0.142	▲3.93	▲5.21	21191.4	19187.1	22/5/18	26/3/18
FTSE SmallCap	5956.62	▼-0.983	▲2.15	▲5.48	6048.96	5551.56	21/5/18	4/4/18
FTSE AIM 100	5674.88	▲0.33	▲4.8	▲15.4	5719.47	4768.33	22/5/18	6/7/17
FTSE All-Share	4244.71	▼-0.792	▲3.86	▲3.2	4324.41	3810.81	22/5/18	26/3/18
S&P 500	2718.1	▼-0.0746	▲3.17	▲13	2872.87	2404.39	26/1/18	24/5/17
Brent Oil Spot $	$79.1065	▼-0.558	▲7.05	▲46.9	$79.68	$44.785	23/5/18	21/6/17
Gold Spot $ per oz	$1305.45	▲1.22	▼-1.97	▲3.78	$1356.22	$1210.35	24/1/18	7/7/17
GBP/USD - US Dollar per British Pound	1.33694	▼-1.05	▼-4.46	▲3.02	1.43407	1.26325	16/4/18	20/6/17
GBP/EUR - Euros per British Pound	1.1401	▼-0.506	▼-0.297	▼-1.35	1.1581	1.0795	16/4/18	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	MTC	Mothercare PLC	▲23
2	BMY	Bloomsbury Publishing PLC	▲19.6
3	GNC	Greencore Group PLC	▲17.8
4	ECM	Electrocomponents PLC	▲15.2
5	CPR	Carpetright PLC	▲14.3
6	BVIC	Britvic PLC	▲10.7
7	ELTA	Electra Private Equity PLC	▲10.3
8	RWI	Renewi PLC	▲10.1
9	OCDO	Ocado Group PLC	▲9.61
10	RTN	Restaurant Group (The) PLC	▲9.07

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	PDL	Petra Diamonds Ltd	▼-25.2
2	NOG	Nostrum Oil & Gas PLC	▼-18.3
3	PETS	Pets at Home Group PLC	▼-16.1
4	HFD	Halfords Group PLC	▼-15.7
5	LMI	Lonmin PLC	▼-14.5
6	DPEU	DP Eurasia NV	▼-13.5
7	TCG	Thomas Cook Group PLC	▼-13
8	ENQ	EnQuest PLC	▼-12.1
9	VED	Vedanta Resources PLC	▼-11.2
10	LSL	LSL Property Services PLC	▼-9.43

Scapa Group (LSE:SCPA)

Scapa Group is a manufacturer and supplier of adhesives for the healthcare and industrial markets. It has manufacturing plants in Europe, US and Asia. Its main business areas are focused on healthcare and industrial markets.

Healthcare

This business works in partnership with major healthcare companies (such as Johnson & Johnson) to develop, manufacture and deliver to market products in three key areas:

- **Advanced Wound Care –** dressings with skin-friendly adhesives that can be used in a number of medical applications with high levels of performance and long wear times.
- **Consumer Wellness –** plasters, bandages, corn plasters and heel cushions sold into consumer markets.
- **Wearable Medical Devices –** a business with similarities to wound care. It focuses on products with skin-friendly adhesives which can stick medical devices such as monitors, drug infusers and testing equipment to a patient's skin.

This business has benefitted from the increasing trend of outsourcing by big healthcare companies in recent years. These companies are under lots of pressure to provide their products at the lowest possible price and they need an efficient way of doing that. One option open to them is to spend a lot of money on research and development, manufacturing plants and logistics. The other option is to give the job to a company such as Scapa.

Scapa's strategy is to offer itself as a one-stop shop that can fulfil the needs of the big healthcare companies. It does so by offering the following capabilities for products:

- Research and development
- Design
- Manufacturing
- Quality and regulation control
- Cost control
- Delivery to market

With plants across the world, Scapa seems well placed to do this for global healthcare companies. It says that it can take a product to market faster than many of its customers can do internally.

In recent years, the company has made a number of acquisitions to boost its product offering. It bought Euromed in 2016 which came with a portfolio of hydrocolloid products that allows Scapa to make inroads into the health and beauty market. In 2017 it bought BioMed which specialises in liquids, powder and gel products which diversifies the business away from adhesives and represents another way of trying to get more business from big healthcare companies.

Scapa has many long-term supply agreements with major healthcare businesses and has large chunks of annual revenue underpinned by contracts. It has a number of new products in development and is confident that recent growth rates in sales can continue - possibly with the help of more acquisitions.

By offering complete product solutions from design right through to delivery, the company is aiming to grow both its revenues and profit margins at the same time.

Scapa Healthcare (£m)	Sales	Trading profit	Margin
2018	112.8	17.4	15.4%
2017	108.7	16.6	15.3%
2016	93.3	14	15.0%
2015	73.8	9.2	12.5%
2014	69.2	10.2	14.7%
2013	57.4	8.4	14.6%
2012	39.5	5.5	13.9%

In recent years it has done a reasonable job with this. Growth in the last financial year just reported has been steady rather than stellar. Its EuroMed acquisition is doing well whilst sales have been decent in medical devices and consumer products. The wound care market is a bit sluggish at the moment.

Going forward, Scapa's healthcare business should be able to continue growing. It has signed a couple of technology transfer deals with healthcare companies that should kick in during the second half of the current financial year, but the company is being realistic when it implies that growth will not be easy to come by.

In its full year results press release Scapa talks about how its revenue stream is heavily reliant on its customers' product launches which often don't match its development pipeline. It also mentions that getting companies to outsource is quite hard work.

The company is very focused on improving its profit margins as a source of future profits growth. It has a medium-term target of getting to 20% profit margins. This will be helped by a new factory in Tennessee which is expected to bring significant cost reductions and efficiency gains.

Industrial

This business specialises in adhesives and tapes that are used in a variety of industrial and specialist applications. Its products are used extensively in the following areas:

- Automotive
- Building
- Insulation
- Data and power cables
- Smartphones and computers

By Scapa's own admission this business is very mature and is unlikely to grow much faster than the global economy. Profits growth in recent years has come mainly from cost cutting, efficiency gains and a focus on return on capital employed (ROCE).

Scapa Industrial (£m)	Sales	Trading profit	Margin
2018	178.7	22.5	12.6%
2017	170.9	17.8	10.4%
2016	153.4	10.7	7.0%
2015	147.8	8.9	6.0%
2014	145.7	7.9	5.4%
2013	140.7	7.2	5.1%
2012	145.9	7.2	4.9%

2017/18 was a fairly decent year with sales growth of 4.6% and profits growth of 26.4% as cost cutting measures gave a significant boost to profit margins. The company remains confident that it can achieve its target of 15% profit margins in the next few years.

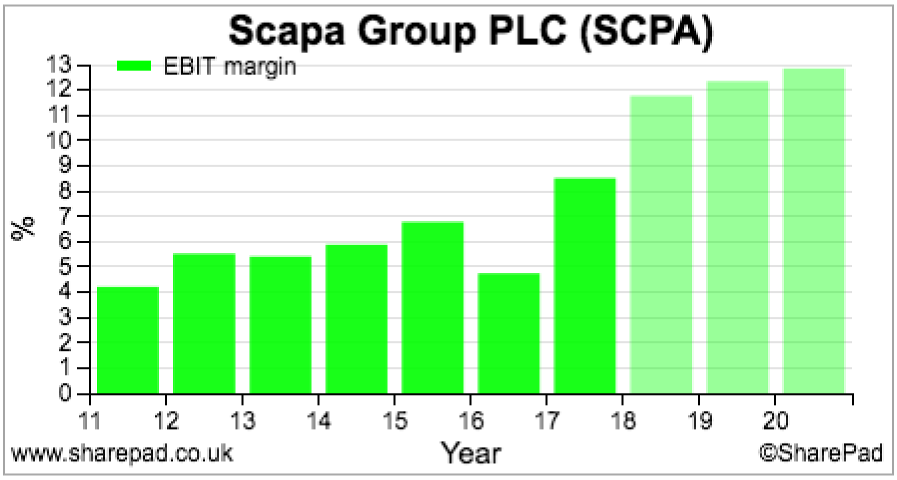
This business is cyclical and will tend to track changes in global economic growth. That said, Scapa sees reasonable prospects in cabling where renewable energy projects will require more connections to electricity grids. The rollout of 5G networks by telecom companies should also provide another source of decent growth as should the shift to more technology components and electric vehicles by automotive companies.

Forecasts, outlook and valuation

Scapa Group PLC (SCPA)

Year	2018		2019		2020	
Turnover	291.1	+4.1%	307.6	+5.6%	315.4	+2.5%
EBITDA	40.6	+20.5%	44.4	+9.3%	47.1	+6.1%
EBIT	34.3	+44.0%	38.0	+10.8%	40.5	+6.8%
Pre-tax profit	33.1	+51.8%	37.0	+11.7%	39.4	+6.7%
Post-tax profit	26.2	+49.1%	28.9	+10.2%	31.1	+7.6%
EPS (p)	17.1	+54.1%	19.0	+11.1%	20.5	+7.9%
Dividend (p)	2.3	+15.0%	2.6	+13.0%	2.8	+7.7%
CAPEX	8.0	-4.8%	8.5	+6.3%	8.5	0.0%
Free cash flow	17.0	+1.8%	21.0	+23.5%	23.0	+9.5%
Net borrowing	3.9	-75.8%	-17.9		-31.3	
NAV	119.0	+18.5%	143.0	+20.2%	161.0	+12.6%

I think Scapa is a fairly decent business but must admit I find it difficult to get a grip on its long-term revenue growth potential, especially when the company talks about the challenges it has to overcome to get the business to grow. The outlook for profits growth is expected to get a significant boost from its push on profit margins and this should help its ROCE move up quite nicely into the high teens percentage on a lease-adjusted basis.



The company's financial position is very strong with net debt of just £3.8m at the end of March 2018 which gives it plenty of firepower to make acquisitions.

One thing that puts me off Scapa is the valuation of its shares. At 480p, the shares trade on a one year forecast rolling PE of more than 25 times. Its growing profit margins and rising ROCE suggest that it is a high-quality business but underlying revenue growth is not exactly stellar, whilst much of the expected profits growth is coming from margin improvements.

The industrial business also has a significant amount of cyclical risk given its exposure to automotive and construction markets which means that it does not have the kind of resilience that would warrant its current high valuation in my view. **The shares look high enough for now.**

Hollywood Bowl (LSE:BOWL)

Generally speaking, I find the leisure sector to be a fairly unattractive place to invest. I find that there are too many businesses chasing too few customers. This tends to make it hard for many companies in the sector to make attractive returns on the money they invest.

On top of that, many leisure activities are highly dependent on discretionary consumer spending. When the economy turns down and people start tightening their belts, sales and profits often take a tumble as well. This makes it hard for leisure companies to produce the steady and predictable profits and cash flows that many investors crave.

I think that Hollywood Bowl, the UK's largest ten-pin bowling operator is a rare example of quality in this sector. I very much like this business, its strategy and the way it is run. You can see my recent in-depth analysis of the company here.

Half year results released on Wednesday this week show that this business is performing very well and that its strategy still has a lot of potential to keep profits growing over the next few years.

The results show that the company has a very attractive business model. Revenues were up by 9.3% with operating profits up by 16.1%. The first half of its financial year between September and March is when Hollywood Bowl makes most of its profits as ten-pin bowling is more appealing during the dark winter days than it is during the summer. Therefore, a good performance in the first half of the year tends to set the company up well for the year as a whole.

Bowling is extremely profitable as there are very little direct costs expensed against revenues (most of the staff and other costs are in selling food and drink in the bowling centres). There is also a lot of operational gearing in the bowling centres as the incremental costs of extra sales is virtually nothing.

	31 March 2018 £000	Restated 31 March 2017 £000
Bowling	**32,254**	28,812
Food and drink	**18,033**	16,644
Amusements	**13,149**	12,453
Other	**202**	321
	63,638	58,230

Like-for-like sales were up by 4% during the first half of the year. The core bowling business seems to be doing very well with total sales up 11.9%. This was driven by new openings but also a very strong underlying performance. Total spend per game was up 5.5% to £9.21 due to new pricing initiatives but Hollywood Bowl still remains the cheapest place to play ten-pin bowling out of all the major operators.

The cost of a game also remains very competitively priced against other leisure activities such as going to the cinema. The number of games played increased by 3.6% to 6.9 million. Food and drink sales were up by 8.3% with amusement sales up by 5.3%.

The relatively high fixed cost nature of the bowling alleys means that the current LFL sales growth is helping to boost profit margins. Underlying costs were well controlled and only increased by 2.8% which fed through to EBITDA growth of 6.4% - faster than LFL revenues – in the existing bowling centres. This helped to increase operating margins from 22.4% to 23.6%.

For me, one of the key attractions of Hollywood Bowl is the profit uplifts it is achieving on refurbishing and rebranding its centres. The typical investment cycle of a bowling centre is six to seven years. The company typically spends around £350,000 on each centre on upgrading its facilities (bars, restaurants, lighting etc) and it has been able to generate some impressive profit increases.

It aims to do 7-10 refurbishments per year with the most recent 11 refurbishments achieving average returns of 55.4%. The returns on the rebranding of nine Bowlplex centres is even higher at 60.2%.

I've often been sceptical of companies quoting very high numbers such as this as when you dig a little bit deeper you find out that they are often not as good as they first appear as it excludes money contributed from grants or landlords.

Fortunately, this is not the case with Hollywood Bowl. The returns are calculated as the extra EBITDA as a percentage of the gross money spent (c£350k). The company does not typically receive money from its landlords for the refurbishment spending.

The calculation of uplifts is also very prudent, as they are compared with the performance of the rest of the estate. To give you an example, if the increase in sales after refurbishment was 13% but the existing estate's sales had increased by 2%, the company would only say that the uplift in sales was 11% as 2% would have happened anyway.

I don't particularly like using EBITDA to measure returns but do use it to measure cash return on cash capital invested (CROCCI). However, assuming the money spent on refurbishments has a seven-year life this would amount to £50,000 per year in depreciation costs. The effect of this would be to reduce an EBITDA return of 55.4% to around 40% which is still very impressive. The company remains confident that its refurbishment programme still has lots of potential to increase group profits.

Bear in mind that we are talking about the incremental ROCE here not the total ROCE of the bowling centres. People often get confused and anchor on to the higher incremental return number thinking the business is stunningly profitable. Hollywood Bowl's ROCE adjusted for leases last year was 13.1%. Given its current trading performance I would expect the company's total ROCE to increase.

Hollywood Bowl's cash flow performance continues to be good. Operating cash flow increased by 28% due to significantly lower working capital outflows than a year ago.

Condensed Consolidated Statement of Cash Flows
For the six months ended 31 March 2018

	Six months ended 31 March 2018 Unaudited £'000	Six months ended 31 March 2017 Unaudited £'000	Year ended 30September 2017 Audited £'000
Cash flows from operating activities			
Profit before tax	14,562	12,408	21,110
Adjusted by:			
Depreciation and impairment	5,304	4,866	9,990
Amortisation of intangible assets	258	265	540
Net interest expense	481	580	1,145
Loss on disposal of property, plant and equipment	53	15	640
Movement on derivative financial instrument	-	(31)	(55)
Share-based payments (Note 12)	143	-	123
Operating profit before working capital changes	20,801	18,103	33,493
Increase in inventories	(163)	(194)	(171)
Decrease in trade and other receivables	565	3,472	2,490
Decrease in payables and provisions	(783)	(5,435)	(3,035)
Cash inflow generated from operations	20,420	15,946	32,777
Interest received	10	3	12
Income tax paid - corporation tax	(2,463)	(976)	(2,905)
Interest paid	(238)	(462)	(975)
Net cash inflow from operating activities	17,729	14,511	28,909
Investing activities			
Purchase of property, plant and equipment	(6,098)	(6,960)	(13,551)
Purchase of intangible assets	(161)	(85)	(196)
Sale of assets	336	139	493
Net cash used in investing activities	(5,923)	(6,906)	(13,254)
Cash flows from financing activities			
Repayment of bank loan	(750)	-	-
Dividends paid	(10,920)	(285)	(2,985)
Net cash flows used in financing activities	(11,670)	(285)	(2,985)
Net change in cash and cash equivalents for the period	136	7,320	12,670

Capex was also slightly lower as spending on new centres was lower. This resulted in free cash flow increasing by 53.6% to £11.5m. This compares very favourably with adjusted post-tax profits of £11.8m indicating that profit quality is very good.

Hollywood Bowl Group PLC (BOWL)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	122.3	+7.3%	128.1	+4.8%	135.2	+5.5%
EBITDA	35.7	+9.2%	37.6	+5.4%	40.0	+6.3%
EBIT	24.6	+11.0%	26.4	+7.6%	28.1	+6.4%
Pre-tax profit	23.7	+12.5%	25.6	+7.9%	27.1	+5.9%
Post-tax profit	18.4	+1.0%	20.3	+10.1%	21.6	+6.8%
EPS (p)	12.4	+2.5%	13.4	+8.1%	14.5	+8.2%
Dividend (p)	6.9	+20.0%	7.5	+8.7%	8.0	+6.7%
CAPEX	12.4	-9.8%	14.3	+15.3%	13.3	-6.8%
Free cash flow	17.9	+17.9%	18.6	+4.1%	20.7	+11.3%
Net borrowing	4.0	-47.9%	-5.2		-11.8	

This is a business that is in a very good place at the moment. The strong momentum from the first half of the year has continued into the second half of the year. I think it should comfortably meet analysts' forecasts for the year to September. It is possible that some slight profit upgrades might materialise later in light of this week's results. Trailing twelve months' operating profit is currently running at £24.2m compared with a current consensus 2018 forecast of £24.6m.

Given the operational gearing within the business, strong LFL sales and the profit uplifts from refurbish-ments I am not surprised to see analysts forecasting further profit margin increases. This should also feed through into improvements in ROCE.

Strong free cash generation is also expected which should move the business into a net cash position next year. This may pave the way for another special dividend payment after one was paid in February this year.

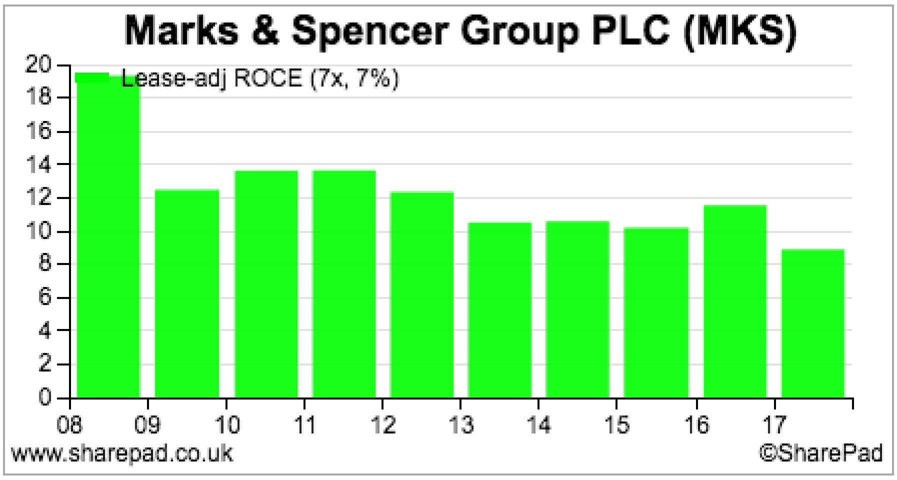
The shares have rerated slightly upwards over the last couple of months and trade on a one year forecast rolling PE of 17.1 times at a share price of 223p whilst offering a prospective yield of 3.1% and decent dividend growth. **I don't think that's overly expensive for a business that is doing a lot of things well at the moment.**

Marks & Spencer (LSE:MKS)

M&S has been a problematic business for years now. Several chief executives have come along over the years and promised to sort it out only to fail to do so. In the fast changing world of retail, it has not changed with the times and has paid a very high price for it. I see it as having five big problems:

1. Its clothing business does not appeal to enough people.
2. Its food offering is too expensive.
3. Its stores are outdated, poorly laid out and in the wrong locations.
4. It has no meaningful online business.
5. It has failed to invest enough in its supply chain and infrastructure

The company has fallen a long way behind its competitors and seen its profitability fall. This is highlighted very clearly in its very modest returns on capital employed (ROCE).



The last financial year was again a tough one. The company ended the year with deteriorating and falling like-for-like sales in both its food and its clothing and home business shown in the table below.

% change	FY	Q1	Q2	Q3	Q4
Food	3.9	4.5	4.4	3.6	3.2
- Like-for-like	-0.3	-0.1	-0.1	-0.4	-0.6
Clothing & Home	-1.4	-0.5	0.6	-2.3	-3.1
- Like-for-like	-1.9	-1.2	-0.1	-2.8	-3.4
Total UK sales	1.8	2.6	2.8	1.1	0.9
- Like-for-like	-0.9	-0.5	-0.1	-1.4	-1.6
International	-10.2	-4.0	-2.2	-10.4	-24.1
Total Group	0.4	1.8	2.2	-0.2	-2.1
M&S.com (Memo only)	5.2	5.3	6.0	2.9	8.0

Despite this backdrop, overall revenues actually increased slightly to £10.7bn on the back of the opening of new Simply Food stores. Operating profits were down by 2.9% but this masks the fact that UK profits were down 14.5% and overseas doubled due to the exiting of loss-making markets in recent years and some helpful currency gains.

The income statement is littered with exceptional items related to the write down in the asset values of UK stores and the costs of trying to get the business back to growth. The company has incurred nearly £1bn of exceptional costs during the last two years. Many of these are non-cash but are an admission of how big the company's problems are and should not be ignored.

52 weeks ended	31 Mar 18 £m	1 Apr 17 £m	Change £m
Strategic programmes			
– UK store estate	(321.1)	(51.6)	(269.5)
– UK organisation	(30.7)	(24.0)	(6.7)
– IT restructure	(15.5)	-	(15.5)
– UK logistics	(13.1)	9.8	(22.9)
– Changes to pay and pensions	(12.9)	(156.0)	143.1
– International store closures and impairments	(5.0)	(132.5)	127.5
UK store impairments, asset write-offs and onerous lease charges	(63.4)	(48.8)	(14.6)
M&S Bank charges incurred in relation to the insurance mis-selling provision	(34.7)	(44.1)	9.4
Other	(17.7)	9.8	(27.5)
Adjusting items	(514.1)	(437.4)	(76.7)

But can M&S be fixed or will it die a slow death?

The company has a plan to improve matters including:

- Closing 25% of its clothing and homewares selling space.
- Reducing costs by at least £350m
- Improving its website and investing in extra warehousing and distribution assets to create capacity for growth.
- Getting rid of layers of unproductive management.

This is all well and good but the company needs a way of meaningfully growing its revenues and wooing people who currently do not shop with it. On the rare occasions I venture into an M&S store I feel that the only people who are shopping in there are the wealthy over 55 age group. Younger people and families are going elsewhere and have been for years.

The company is trying to woo younger customers by cutting back on its clothing ranges, buying in more stylish products and cutting its prices to make its products better value for money. It says that it grew its customer numbers for the first time in five years last year.

I'm not convinced that just opening more Simply Food stores is a great strategy. In my opinion, whilst the quality of food in M&S is very good, its pricing is way out of kilter with other shops. Given that more people are buying food online, I think it is disappointing that M&S has not mentioned any plans to start selling its whole food range over the internet as part of its strategy. Its current food website offers only 444 items for sale. I think this needs a serious upgrade and investment to create a more attractive business for customers.

The main attraction that M&S has at the moment is that its cash flows remain quite reasonable.

12 Analysis of cash flows given in the statement of cash flows

Cash flows from operating activities

	2018 £m	2017 £m
Profit on ordinary activities after taxation	29.1	115.7
Income tax expense	37.7	60.7
Finance costs	113.8	113.0
Finance income	(24.1)	(36.2)
Operating profit	156.5	253.2
(Increase)/decrease in inventories	(38.2)	53.9
Decrease/(increase) in receivables	28.8	(9.9)
Decrease in payables	(87.4)	(51.5)
Adjusting items net cash outflows	(153.1)	(36.8)
Non-cash share-based payment charges	18.9	10.6
Depreciation, amortisation and write-offs	580.6	589.5
Defined benefit pension funding	(41.4)	(36.6)
Adjusting items non-cash	(34.7)	(44.1)
Adjusting operating profit items	514.1	437.4
Cash generated from operations	944.1	1,165.7

Operating cash flow fell by 19% last year due to lower profitability and higher working capital outflows. Free cash flow for shareholders fell from £546m to £388m. However, this is still enough to cover the cash cost of its current annual dividend per share of 18.7p (£303.8m). This is why M&S has decided to maintain its dividend and was probably the reason why its share price increased by more than 5% on Wednesday when there were probably some grounds for thinking that it might be cut.

Looking at the forecasts in SharePad below, free cash flow forecasts are over £500m for the next couple of years. This suggests that its dividend can be maintained. The key risk here is that more money is needed to invest in IT and logistics to create a competitive online business which might then require a dividend cut to free up the cash to do this.

Marks & Spencer Group PLC (MKS)						
FORECASTS					£ millions unless stated	
Year	**2018**		**2019**		**2020**	
Turnover	10,780.9	+1.5%	10,861.8	+0.8%	10,967.9	+1.0%
EBITDA	1,232.6	-5.4%	1,192.8	-3.2%	1,188.6	-0.4%
EBIT	656.8	-8.0%	616.3	-6.2%	621.3	+0.8%
Pre-tax profit	571.7	-6.9%	548.1	-4.1%	558.9	+2.0%
Post-tax profit	453.1	+12.2%	426.6	-5.9%	440.0	+3.1%
EPS (p)	27.8	+12.1%	26.5	-4.7%	27.2	+2.6%
Dividend (p)	18.4	-1.6%	18.5	+0.5%	19.0	+2.7%
CAPEX	318.9	-22.3%	364.7	+14.4%	385.5	+5.7%
Free cash flow	525.4	-17.1%	547.2	+4.2%	524.9	-4.1%
Net borrowing	1,760.3	-0.0%	1,582.9	-10.1%	1,426.9	-9.9%
NAV	3,266.5	+3.5%	3,368.0	+3.1%	3,491.0	+3.7%
Like for like sales growth %	-2.0		1.0		2.2	+120.0%

At 307p, the shares offer a 6.1% dividend yield but I'm not sure that is enough to lure new buyers. M&S needs to start growing again and this week's announcements are far from convincing that it has the right strategy and right assets to do that.

Of course, I may be proved wrong, but I see little reason even for contrarian value investors to buy the shares at the moment.