Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope

05 July 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7603.22	▼-0.163	▼-1.09	▲3.2	7877.45	6888.69	22/5/18	26/3/18
FTSE 250	20621.1	▼-0.305	▼-2.05	▲6.01	21324	19187.1	14/6/18	26/3/18
FTSE SmallCap	5882.66	▼-0.229	▼-1.35	▲5.4	6048.96	5551.56	21/5/18	4/4/18
FTSE AIM 100	5685.04	▲0.975	▼-0.298	▲18.5	5809.07	4768.33	14/6/18	6/7/17
FTSE All-Share	4180.73	▼-0.188	▼-1.25	▲3.75	4324.41	3810.81	22/5/18	26/3/18
S&P 500	2728.17	▲0.437	▼-0.751	▲12.2	2872.87	2409.75	26/1/18	6/7/17
Brent Oil Spot $	$78.255	▲0.974	▲4.36	▲61.9	$79.68	$46.905	23/5/18	7/7/17
Gold Spot $ per oz	$1257.66	▲0.721	▼-3.03	▲2.53	$1356.22	$1210.35	24/1/18	7/7/17
GBP/USD - US Dollar per British Pound	1.32156	▲1.07	▼-1.42	▲2.2	1.43407	1.27997	16/4/18	24/8/17
GBP/EUR - Euros per British Pound	1.13005	▼-0.0663	▼-1.16	▼-0.847	1.1581	1.0795	16/4/18	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	CWD	Countrywide PLC	▲38.5
2	VED	Vedanta Resources PLC	▲26.3
3	DPEU	DP Eurasia NV	▲12.7
4	SDRY	Superdry PLC	▲11.7
5	SGC	Stagecoach Group PLC	▲10.7
6	IHP	IntegraFin Holdings PLC	▲9.43
7	MGGT	Meggitt PLC	▲9.26
8	PFD	Premier Foods PLC	▲9.21
9	ITE	ITE Group PLC	▲8.61
10	OSB	OneSavings Bank PLC	▲8.59

Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	PTEC	Playtech PLC	▼-28.4
2	SOPH	Sophos Group PLC	▼-20.6
3	ELM	Elementis PLC	▼-14.4
4	MOTR	Motorpoint Group PLC	▼-9.5
5	BOWL	Hollywood Bowl Group PLC	▼-9.17
6	GLEN	Glencore PLC	▼-9.11
7	CNE	Cairn Energy PLC	▼-8.87
8	ALM	Allied Minds PLC	▼-8.33
9	HTG	Hunting PLC	▼-8.16
10	LWB	Low & Bonar PLC	▼-7.77

Greene King (LSE:GNK)

My first job in the world of investment was analysing pub companies. Over the last 20 years or so, I've seen nothing to change my view that running pubs is a very hard way to make decent returns on your money.

Despite the fact that many pubs have closed over the last decade, competition in this sector is intense. Pubs are not just competing with other pubs but with restaurants, take-away food outlets and supermarkets. Given all the costs that are involved with running a pub, the challenge to offer good value food and drink that is attractive to increasingly cash-strapped consumers is a tough one.

Competition, high levels of investment in assets and high costs means that returns on capital employed (ROCE) in the pub sector struggle to get above 10% in many cases. Getting pub sales and profits to grow is beyond many operators at the moment.

This has been the experience of Greene King over the last few years and was highlighted quite clearly in its full year results which were released last week. Its three key divisions of managed pubs, tenanted pubs and brewing all saw their profits fall last year.

Looking at its managed pubs (Pub Company) which is Greene King's biggest source of profits, you can see how the impact of a decline in revenue, combined with a rise in costs, can feed through to a material fall in profits. Like-for-like sales fell by 1.7% last year but a big rise in costs – mainly wages, utilities and business rates – saw operating profits fall by nearly £40m. This result would have been a lot worse if the company had not been able to save around £44m to offset £60m of cost increases.

Pub Company

Greene King's problem is that its costs are expected to increase by a further £45-50m this year and that it only expects to achieve around £30-£35m in cost savings. The £10-£15m difference is going to have to be plugged by increasing like-for-like sales in a profitable way.

52 weeks	F18	F17	YOY Change
Ave. no. of pubs trading	1,733	1,812	-4.4%
Revenue	GBP1,767.7m	GBP1,817.4m	-2.7%
EBITDA(1)	GBP362.9m	GBP403.2m	-10.0%
Operating profit(1)	GBP268.2m	GBP308.1m	-13.0%
Operating profit margin(1)	15.2%	17.0%	-1.8%pts
Ave. EBITDA per pub(1)	GBP209.4k	GBP222.5k	-5.9%

The company has been making selected investments in its product offer in order to woo customers and this looks to have had some success as like-for-like sales have increased by 2.2% during the first eight weeks of its new financial year. England's success in the World Cup and the recent hot weather are also likely to have been helpful in increasing sales.

Greene King is also simplifying its business and consolidating its pub brands to target key areas of the pub market. This makes sense and should help with overall management of the business.

Competition is not going to go away but it seems that Greene King may have given itself a fighting chance of at least maintaining profits in its core pub business, providing that trading conditions hold up.

Pub Partners

Pub Partners which consists of 1,100 drink-led pubs has maintained its status as a steady source of profits, albeit one where there doesn't seem to be much growth. This is a business where it is important not to squeeze tenant landlords too hard with onerous rent and beer supply agreements.

52 weeks	F18	F17	YOY Change
Ave. no. of pubs trading	1,140	1,196	-4.7%
Revenue	GBP193.9m	GBP198.8m	-2.5%
EBITDA(1)	GBP101.3m	GBP103.1m	-1.7%
Operating profit(1)	GBP91.4m	GBP92.8m	-1.5%
Operating profit margin(1)	47.1%	46.7%	+0.4%pts
Ave. EBITDA per pub(1)	GBP88.9k	GBP86.2k	+3.1%

Profits fell last year due to a lower number of pubs but the growth in average EBITDA per pub of 3.1% is reasonable in a tough market.

Brewing

Greene King owns some very good ale brands such as Greene King IPA and Old Speckled Hen. The company is still growing the amount of beer that it sells and is taking market share in a declining market but profits are not growing as gross margins have fallen due to changes in sales mix. This business remains a good source of cash generation for the company.

52 weeks	F18	F17	YOY Change
Revenue	GBP215.1m	GBP200.3m	+7.4%
EBITDA(1)	GBP36.0m	GBP36.2m	-0.6%
Operating profit(1)	GBP30.7m	GBP31.0m	-1.0%
Operating profit margin(1)	14.3%	15.5%	-1.2%pts

Given how tough trading conditions are for Greene King and its peers at the moment and how difficult it is to generate meaningful profits growth it's reasonable to question the case for investing in its shares.

Despite its troubles, the company still generates decent cash flows and has the asset backing of an 82% freehold pub estate. As you can see from the screenshot below, the company is still generating enough cash flow to pay its dividend. Taking its adjusted cash generated from operations and deducting its core capital expenditure –needed to keep its existing pubs in decent condition – resulted in £195m of cash left over (2017:£220.4m) compared with the cash cost of dividends of £102.9m.

GBP million	52 weeks ended 29 April 2018	52 weeks ended 30 April 2017
Adjusted EBITDA(1)	486.6	524.1
Working capital and other movements(2)	(22.9)	(14.8)
Net interest paid(2)	(127.1)	(134.9)
Tax paid(2)	(9.4)	(28.0)
Adjusted cash generated from operations	327.2	346.4
Core capital expenditure	(132.2)	(126.0)
Dividend	(102.9)	(100.1)
Net repayment of trade loans/ Other non-cash movements	(2.2)	(0.7)
Free cash flow	89.9	119.6
Disposal proceeds	117.5	88.6
New build/ brand conversion capital expenditure	(61.0)	(68.9)
Exceptional and non-underlying items/ share issues	(61.6)	(48.0)
Payment of derivative liabilities	(42.6)	(117.4)
Change in net debt	42.2	(26.1)

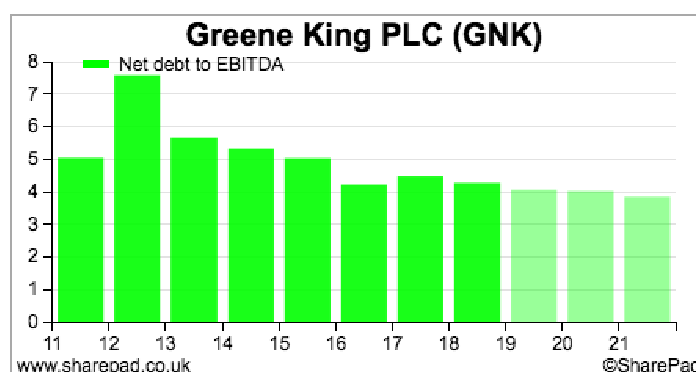
Greene King also regularly sells off a selection of its poorly performing pubs to raise cash. It can do this because it owns the freehold of most of its pubs. These assets have significant value and are bought by other pub companies or sold for alternative use such as property development. The £117.5m raised last year helped to fund the building of new pubs and brand conversions with enough money left over for a modest reduction in net debt.

Greene King PLC (GNK)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	2,189.4	+0.6%	2,200.2	+0.5%	2,246.2	+2.1%
EBITDA	488.3	+2.5%	485.1	-0.6%	486.0	+0.2%
EBIT	373.3	+2.9%	369.9	-0.9%	374.4	+1.2%
Pre-tax profit	244.3	+5.5%	245.7	+0.6%	252.6	+2.8%
Post-tax profit	190.5	-0.0%	195.5	+2.7%	200.1	+2.3%
EPS (p)	63.1	+2.9%	64.0	+1.4%	66.0	+3.1%
Dividend (p)	33.7	+1.5%	33.9	+0.6%	35.0	+3.2%
CAPEX	193.3	+0.1%	194.8	+0.8%	189.5	-2.7%
Free cash flow	114.4	+64.9%	118.8	+3.9%	158.1	+33.1%
Net borrowing	1,984.1	-2.4%	1,951.3	-1.7%	1,866.1	-4.4%

I therefore think Greene King's dividend is reasonably safe for now but the fact that it was maintained last year suggests that dividend growth may be hard to come by for the next few years. The company still has a lot of debt with net debt to EBITDA expected to be around 4 times this year and is not expected to come down too much thereafter. Interest cover is just under three times. That's just about in the comfort range and investors probably wouldn't want it to fall much lower.



Given the trading backdrop, it's not really surprising that Greene King shares are trading on a fairly modest valuation. The shares are valued similarly to other struggling pub shares on a forecast EV/EBIT basis which takes into account the value of company debts.

TIDM	Name	Close	Market Cap. (m)	PE roll 1	Yield	Lease-adj ROCE (7x, 7%)	fc EV/EBIT
GNK	Greene King PLC	560p	£1736.0	8.9	5.9	7.4	10.1
JDW	Wetherspoon (J D) PLC	£12.32	£1299.8	16.5	1.0	10.2	15.1
MAB	Mitchells & Butlers PLC	259.2p	£1110.2	7.5	2.9	6.0	10.6
EIG	EI Group PLC	146p	£681.5	7.0		6.0	10.5
MARS	Marston's PLC	99.5p	£657.1	6.9	7.5	6.6	10.8
FSTA	Fuller Smith & Turner …	980p	£540.0	15.1	2.0	7.5	15.1
CPC	City Pub Group PLC (…	224.5p	£131.3	25.5	1.0	1.6	22.0
RBG	Revolution Bars Group…	143.1p	£71.6	9.2	3.5	10.9	10.1

The high forecast dividend yield might attract some income seekers but the lack of dividend growth will surely put some people off. The shares had rallied quite strongly before the release of its results but have fallen back sharply since last week. It's difficult to see them being re-rated upwards any time soon but the recent hot weather and World Cup effect might stop them from falling back too much.

Sainsbury (J) (LSE:SBRY)

Sainsbury's is a business going through a tough time. Its supermarkets are struggling to grow in a cut-throat market. This is what has led it to pursue a merger with its rival Asda.

There is no certainty that the merger will be allowed to go ahead, especially as there are strong grounds for arguing that customer choice and supplier profits are unlikely to benefit. Undoubtedly, lots of costs can be cut but Sainsbury's challenge – with or without Asda – remains the same: how can it get more shoppers through its doors?

Wednesday's first quarter trading statement suggested that Sainsbury's is finding this hard. Like-for-like sales (excluding fuel) for the first 16 weeks of its financial year increased by just 0.2% as the company has had to cut its grocery prices in order to stay competitive. The problem is that these lower prices have not seen sales volumes – the amount of goods purchased by customers – increase enough to deliver meaningful sales growth.

On a positive note, clothing sales and Argos in particular seem to be doing well. Argos stores in Sainsbury's supermarkets have grown sales by an average of 15% in their second year of trading. This is a very encouraging result and when combined with the cost savings from the acquisition will keep Sainsbury's profits growing.

Looking further out at current consensus forecasts it seems that 2021 is expected to see a sharp increase in sales and profits without assuming a merger with Asda. This looks wrong to me and I would not pay too much attention to the forecast.

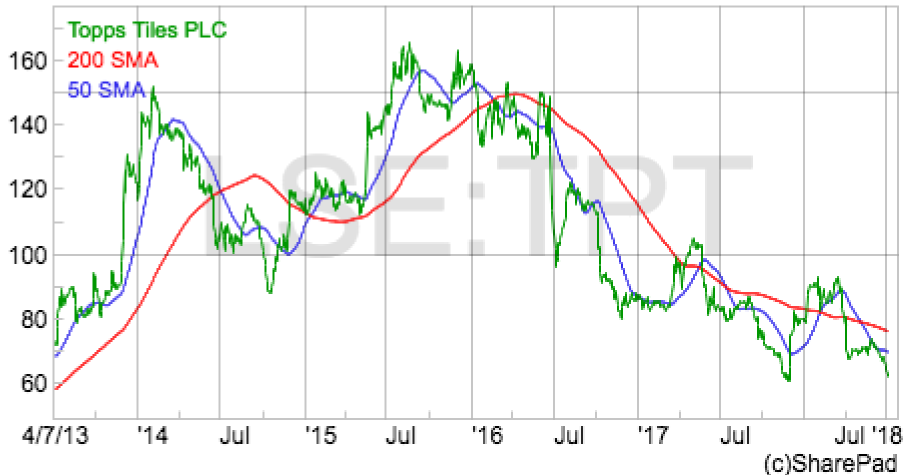
Sainsbury (J) PLC (SBRY)						
FORECASTS						£ millions unless stated
Year	2019		2020		2021	
Turnover	28,765.0	+1.1%	29,666.8	+3.1%	31,670.8	+6.8%
EBITDA	1,423.6	+14.0%	1,490.4	+4.7%	1,642.6	+10.2%
EBIT	724.1	+39.8%	779.0	+7.6%	905.4	+16.2%
Pre-tax profit	644.7	+57.6%	690.5	+7.1%	858.1	+24.3%
Post-tax profit	483.6	+56.5%	545.6	+12.8%	637.2	+16.8%
EPS (p)	20.8	+63.8%	21.9	+5.3%	24.9	+13.7%
Dividend (p)	10.6	+241.9%	11.5	+8.5%	12.6	+9.6%
CAPEX	656.3	-6.4%	642.4	-2.1%	702.2	+9.3%
Free cash flow	496.7	-29.8%	566.7	+14.1%	618.2	+9.1%
Net borrowing	1,388.7	+172.3%	1,453.1	+4.6%	1,389.5	-4.4%

I still think that Sainsbury's grocery business is stuck in a rut. Its perceived customer proposition is not as good as Tesco's or Morrisons' and it cannot compete with either of them on value –never mind the discount retailers such as Aldi and Lidl – despite cutting prices. This is the main reason why its profitability has been so disappointing in recent years.

To try and get around this it has bought Argos – which, to be fair, looks like a reasonable deal – and with it the potential to grow profits by cutting costs. The proposed deal with Asda is another big opportunity to do the same. If the deal goes ahead, then the combined business will be a lot more profitable (higher margins and a half respectable ROCE) than Sainsbury's is now and the shares may look cheap at today's share price. See my roundup from 3rd May 2018 for a detailed review of the Asda deal.

If the deal is blocked or requires lots of store disposals then I see Sainsbury's continuing to struggle in the UK supermarket sector as it needs higher levels of footfall to make it stores more profitable than they are now. I think to do this it will need to take customers from Tesco and Morrisons and I'm not convinced that it has done enough to change long-held consumer perceptions that it is a more expensive place to shop.

Topps Tiles (LSE:TPT)

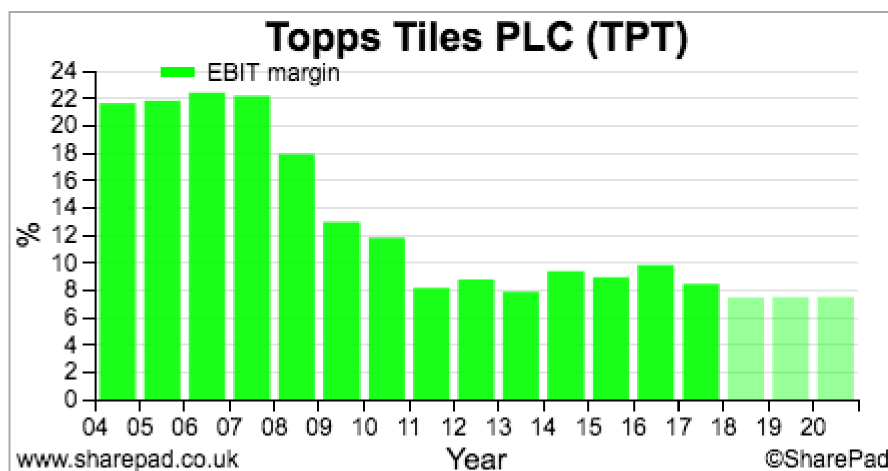


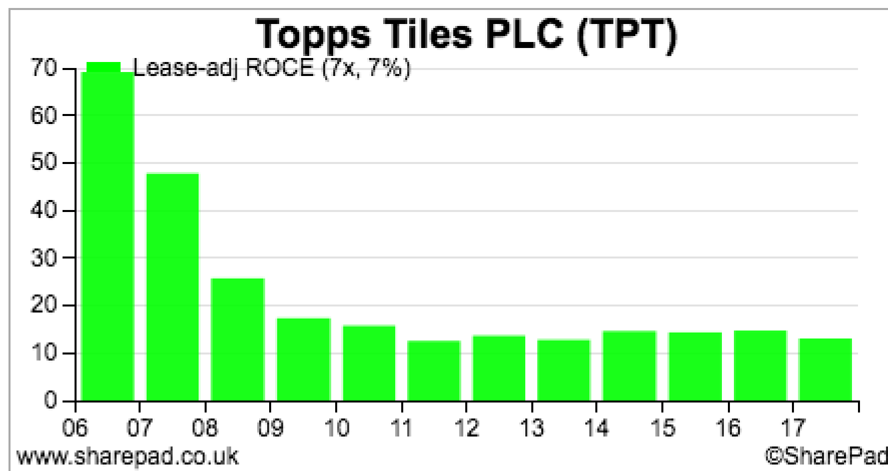
Topps Tiles is something of a bellwether on the health of the UK consumer and the housing market. A buoyant housing market tends to stimulate home improvement projects which can mean buying more tiles and flooring from places such as Topps. I've bought from them in the past and think it is a decent place to shop and have been impressed with its product range.

Life is quite tough for the company at the moment. Third quarter LFL sales declined by 2.3% following a decline of 2.2% in the second quarter. The company is trading from eight more stores than a year ago (375) and is trying to grab a bigger slice of the commercial tile market.

The company's profitability was decimated during the last recession and has not recovered. Profit margins and ROCE are a shadow of their former impressive levels.

Despite this spectacular fall from grace, it still looks like a half reasonable retailer with profit margins of more than 8% and a lease-adjusted ROCE last year of 13.1%. Topps' problem is a lack of growth. There has been little in the way of sales or profits growth for the last four years and by the look of analysts' forecasts this doesn't look like changing much. Given the weakening secondary housing market in the UK, I think these forecasts look sensible.





The focus is very much on keeping costs under control and generating as much cash flow as possible. As long as trading does not get much worse, the business should convert most of its profits into free cash flow which suggests that its dividend–and 5.2% forecast yield–looks safe for now. It also means the company should be able to pay down some debt as well which will de-risk the business for shareholders a little.

Topps Tiles PLC (TPT)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	216.4	+2.1%	221.8	+2.5%	229.4	+3.4%
EBITDA	22.7	-7.0%	23.8	+4.8%	24.4	+2.4%
EBIT	16.2	-9.8%	16.6	+2.9%	17.2	+3.7%
Pre-tax profit	15.9	-6.5%	16.3	+2.6%	17.5	+7.1%
Post-tax profit	12.4	-7.4%	12.9	+3.4%	13.7	+6.2%
EPS (p)	6.5	-5.8%	6.7	+3.1%	7.2	+7.5%
Dividend (p)	3.3	-2.9%	3.4	+3.0%	3.6	+5.9%
CAPEX	9.5	-6.5%	9.5	0.0%	9.5	0.0%
Free cash flow	12.7	+153.9%	10.7	-16.2%	11.1	+4.1%
Net borrowing	22.3	-18.7%	17.7	-20.9%	12.7	-27.9%

I don't think this is a really bad business but the lack of growth is a concern. All its sales come from the UK where it has a retail market share of just over a third but still a very small share of the commercial market. Given the state of consumer confidence and the secondary housing market in the UK, I struggle to see a positive outlook for the company.

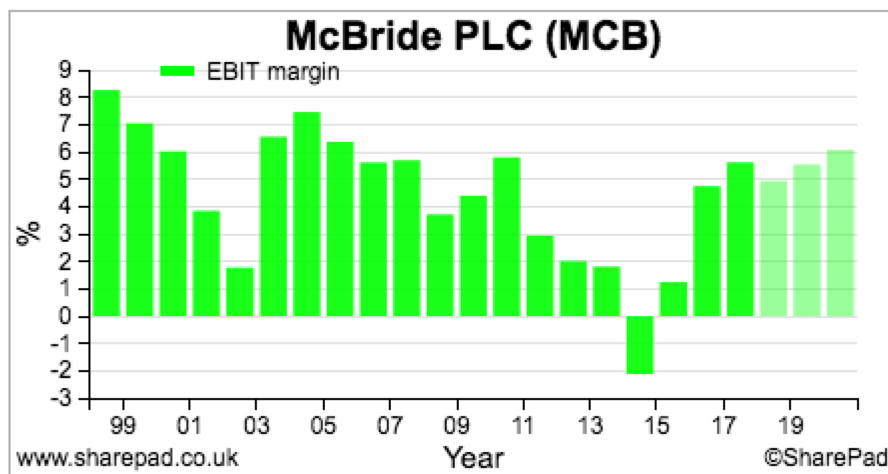
The shares have been hammered so far in 2018 and are down by more than 20% this year. They don't look expensive on a one-year rolling forecast PE of just over 9 times but that looks about right to me for a business with a lacklustre growth outlook.

McBride (LSE:MCB)

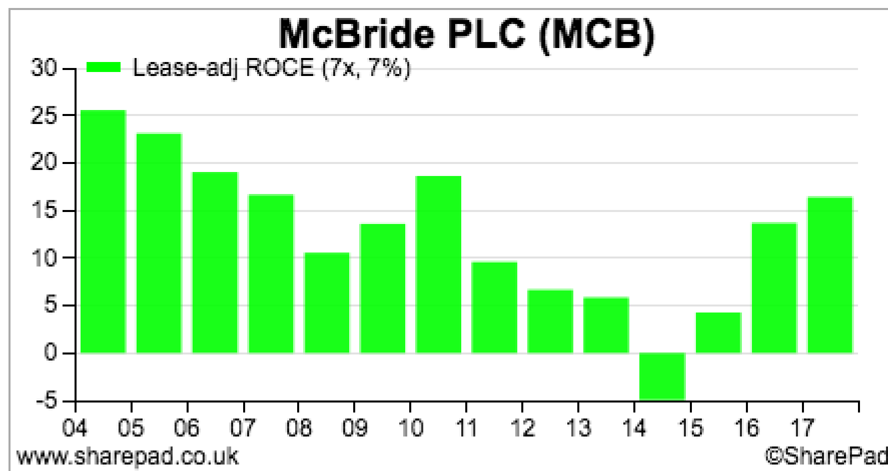
McBride makes own label household and personal care products that are sold to supermarket customers across Europe. Many of the own label washing tablets, dishwasher tablets, cleaning products, shampoos, shower gels, deodorants and toothpastes that you will see in your local supermarket are made by McBride.

Own or private label products have seen considerable growth as they have improved in quality to rival big name brands. The supermarkets have been keen to push them to their customers as a way of making better profits.

Investors often mistake growth in a market as automatically being good for the companies that serve it. This has not been the case for McBride for a long time. Its problem is that its customers are too powerful and can beat it down on price or refuse to allow it to recover raw material cost increases.



As a result, the company's profits and its margins have been very volatile. That said, this is a business that has been capable of making very respectable returns on capital from time to time.



Having looked at this company a few times over the years, I get the impression that it regularly has to restructure its business in order to hang onto its profits which does not seem to be a great position to be in. 2018 is looking to be another tough year. This week's trading update contained a profit warning which said that full year profits would be below the bottom of the range of current analyst expectations. This was due to weaker than expected sales and the personal care and aerosols business losing more money than expected. The company still hopes to get this business back to a position of breakeven in a year's time.

The household products business has performed better with second half sales increasing by 3.8% on a like-for-like basis. This part of the company accounts for over 80% of total sales and does have some potential based on my own experience.

Personally, I think own label washing and dishwasher tablets are very good, especially the premium versions of them. They are just as good – if not better than – major brands and are certainly a lot cheaper.

For example, Finish dishwasher tablets don't work well in the Oakley family dishwasher but Morrisons premium product does a great job. Bulls amongst City analysts see washing and dishwasher tablets as the key driver of value for McBride.

I'm less convinced that people will choose own label shampoos and toothpaste over branded products. Given that personal care has been losing money I can't help thinking that McBride and its shareholders would be better off if it got out of this business.

Despite being reasonably positive about the prospects for some of its business, this week's announcement that Tesco and Carrefour are going to combine their buying power must have sent a shiver down the spines at McBride's head office.

If Sainsbury's and Asda also get together then I can see life getting a lot tougher for the company. You can't help thinking that it's a lot easier for the supermarket giants to push down McBride's margins to help their profits grow than it is with a company such as Unilever.

McBride PLC (MCB)						
FORECASTS						£ millions unless stated
Year	2018		2019		2020	
Turnover	759.2	+7.7%	783.0	+3.1%	795.2	+1.6%
EBITDA	58.5	-2.0%	65.5	+11.9%	71.1	+8.6%
EBIT	37.5	-5.4%	43.3	+15.7%	48.3	+11.3%
Pre-tax profit	32.8	-1.1%	38.0	+15.6%	43.0	+13.4%
Post-tax profit	19.1	-5.8%	26.4	+38.3%	29.6	+12.3%
EPS (p)	12.5	+12.6%	14.7	+17.6%	16.8	+14.3%
Dividend (p)	4.4	+2.3%	5.0	+13.6%	5.7	+14.0%
CAPEX	24.8	+39.8%	27.1	+9.4%	26.7	-1.3%
Free cash flow	17.1	-12.9%	25.3	+48.3%	29.7	+17.2%
Net borrowing	110.6	+46.1%	100.3	-9.3%	87.0	-13.3%

These developments make me question whether analyst forecasts for the next few years are currently too high. The gains from sorting out the losses at Personal Care could be offset by price cuts elsewhere. McBride's shares may look cheap on a rolling forecast PE of 8.5 times but weak bargaining power with its customers is not going to go away anytime soon and could be about to get a lot worse.

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