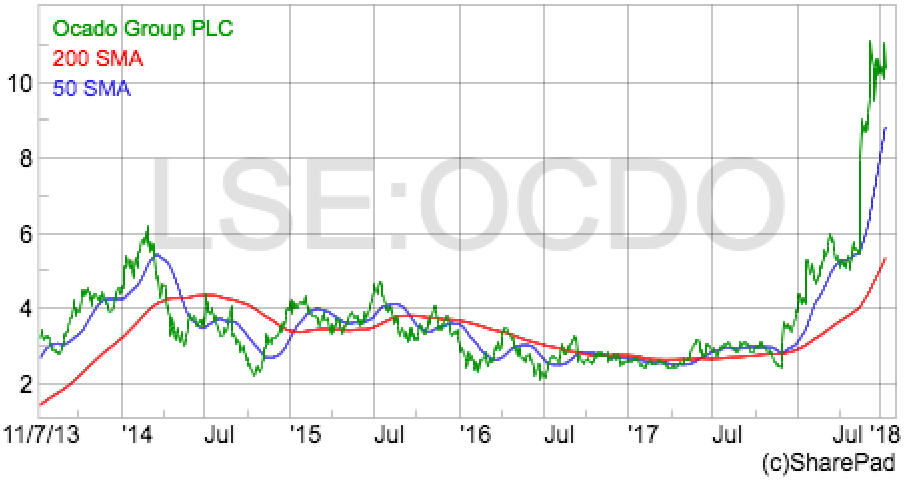
Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope

11 July 2018

Due to the holiday season beginning in earnest at ShareScope headquarters, this week's roundup will be briefer than usual. Instead of the usual deep dive and number crunching into the key issues relating to companies in the news, I will give some quick-fire thoughts instead. I hope you will still find it interesting.

Ocado (LSE:OCD)



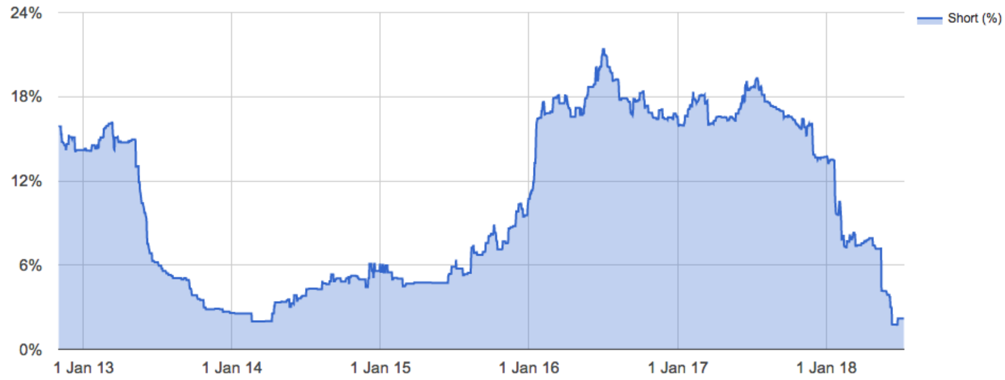
Ocado has long been a business that has divided opinion. Bears have frequently pointed to the fact that its share price and the valuation of the business has contained large amounts of froth that couldn't even come close to being justified by the profit it was making or could hope to make. Bulls see it as a transformational technology company that will change the way food retail companies serve their customers.

Despite the surge in its share price this year, nothing really has changed in my opinion. The share price has gone up as short sellers have capitulated in the face of positive news flow from the company. New contracts to use Ocado's technology from US retailer Kroger and French supermarket Casino give some weight to the view that it can become a significant retail technology company.

This may or may not happen but Ocado's valuation has become more extreme in the meantime. Just because a company is perceived as a technology business is not a reason to value it at extreme levels. There can be no doubt that Ocado's valuation is extreme. The company is expected to make post-tax loss of £11.6m this year according to the consensus estimates of 20 analysts on SharePad but its equity is valued at a whopping £7.7bn.

At the moment this doesn't seem to worry the market. Ocado is a story stock where valuation doesn't seem to matter. Short interest has almost evaporated from more than 20% of its shares being out on loan to short sellers to just over 2% now according to shorttracker.co.uk.

Ocado short position (% of stock on loan)



Source:shorttracker.co.uk

In many ways, Ocado is symptomatic of the stock market as a whole at the moment. Valuation seems to be a minor consideration for the shares of many companies – it's all about momentum. If the business is doing well and beating expectations it will keep on going up. Some people are very good at making money out of shares such as Ocado but it is a dangerous strategy.

One piece of bad news is all that is needed for the share price to suffer a significant fall because the expectations of growth baked into the share price are so high.

If you are a believer in the long-term prospects of Ocado and are thinking about buying the shares at a valuation that gives you some protection from things going wrong – what Ben Graham referred to as the all-important margin of safety – then you have to give some thought as to how much money the business can ultimately make. Put another way, what level of profit is needed to justify the current market cap of £7.7bn?

I don’t have the time in this newsletter to do an in-depth study of Ocado and forecast cash flows way into the future to work out the answer to this question. A rough and ready approximation might be to try and say what steady state profits of this company could be and put that on a multiple of say 15 times. £7.7bn dividend by 15 implies post tax profits of just over £500m.

Ocado Group PLC (OCDO)

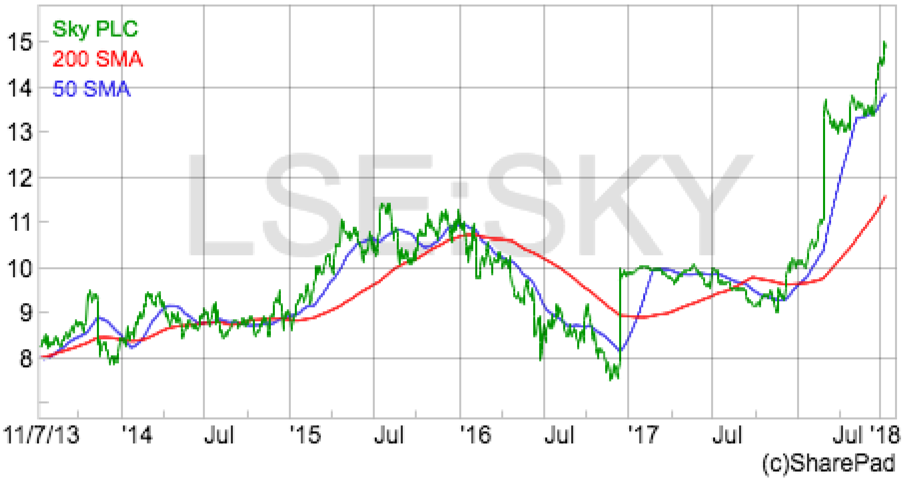
FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	1,621.6	+10.8%	1,828.5	+12.8%	2,128.7	+16.4%
EBITDA	89.5	+4.1%	110.7	+23.7%	149.6	+35.1%
EBIT	13.4	-10.7%	26.5	+98.2%	41.7	+57.1%
Pre-tax profit	-14.9		-1.3		10.5	
Post-tax profit	-11.6		-0.1		14.2	
EPS (p)	-2.0		-0.3		4.1	
Dividend (p)	-		-		-	
CAPEX	207.2	+22.3%	209.2	+1.0%	245.8	+17.5%
Free cash flow	-120.0		-105.1		-97.5	
Net borrowing	186.6	-18.1%	220.9	+18.4%	349.9	+58.4%
NAV	393.4	+45.3%	391.3	-0.5%	519.3	+32.7%

Based on current forecasts, Ocado is nowhere near to achieving this anytime soon. In fact, heavy investment to support its new contracts is going to see free cash flows staying negative for a while yet.

Ocado deserves a lot of credit for winning new contracts but unfortunately its share price looks as if it has priced in a very rosy future for the business that looks a long way off.

Sky (LSE:SKY)



Having just rambled on about the valuation of Ocado, the current bidding war for pay-TV and media company Sky is an interesting case study in how much people are willing to pay for a business.

21st Century Fox is in a battle with US communications company Comcast for control of Sky. To complicate matters further, Walt Disney and Comcast are also trying to buy 21st Century Fox at the same time. The latest offer of £14 per share by 21st Century Fox values Sky's equity at £24.06bn or 21.6 times 2018 forecast earnings.

Sky PLC (SKY)

FORECASTS — £ millions unless stated

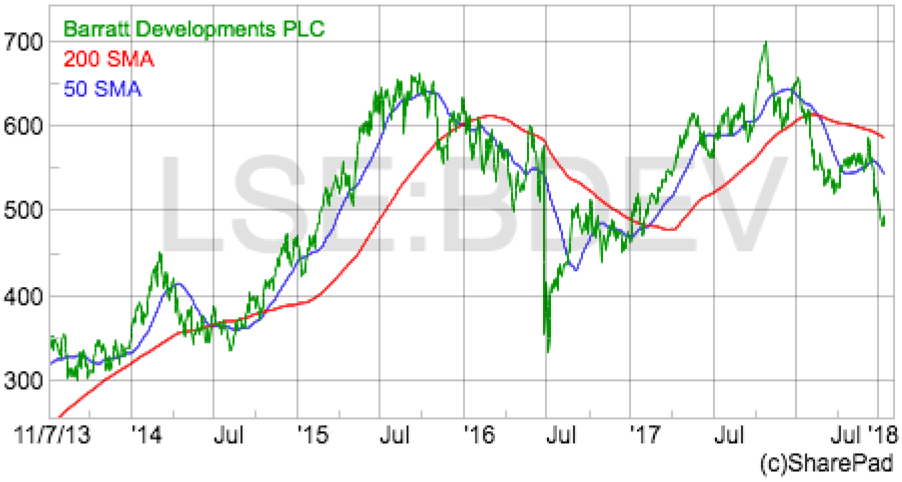
Year	2018		2019		2020	
Turnover	13,603.0	+5.3%	14,216.8	+4.5%	14,917.2	+4.9%
EBITDA	2,340.8	+7.9%	2,464.5	+5.3%	2,722.6	+10.5%
EBIT	1,565.3	+30.8%	1,647.1	+5.2%	1,828.4	+11.0%
Pre-tax profit	1,362.3	+43.1%	1,440.3	+5.7%	1,762.2	+22.4%
Post-tax profit	1,113.0	+35.2%	1,156.8	+3.9%	1,335.8	+15.5%
EPS (p)	64.8	+36.7%	67.9	+4.8%	78.2	+15.2%
Dividend (p)	35.0		36.1	+3.1%	41.5	+15.0%
CAPEX	1,009.3	-14.0%	999.4	-1.0%	952.5	-4.7%
Free cash flow	845.4	+19.1%	1,079.8	+27.7%	1,353.9	+25.4%
Net borrowing	6,139.2	-12.1%	5,488.4	-10.6%	4,280.1	-22.0%

In my humble opinion, Sky is a business that faces many challenges. Its pay TV products are expensive and face tough competition from cheaper streaming products in the form of Netflix and Amazon Prime. Its sports channels have to pay huge amounts to retain the rights to premier league football which makes it hard for this part of the business to make acceptable levels of profits.

Yet Sky has something that others seem to want in the form of pay TV businesses in big markets such as the UK, Germany and Italy. For a company such as Comcast, which faces a very challenging home market in the US, the combination of content from 21st Century Fox and a platform for distributing it in Europe is a way of dealing with its problem.

Sky's current share price of 1488p at the time of writing indicates that the latest offer is not a knockout one. It would not surprise me that eventually this business is sold for more than 1600p (a PE of 25x) given the perception that Sky is a valuable and scarce asset.

Barratt Developments (LSE:BDEV)



Regular readers of this newsletter will be aware of my bearish stance on housebuilders and may be even slightly bored of it. I just find it hard to believe in the health of the industry when house prices are very expensive relative to people's incomes and the sale of newly built homes is highly dependent on subsidised mortgages in the form of the Help to Buy scheme.

Help to Buy has undoubtedly allowed builders to make higher profits than they otherwise would have done without it in my opinion. If I just look at my local market in Essex, the premium for new build houses versus comparable existing ones seems to be very big and getting bigger.

I think this situation has developed because mortgage lenders are only on the hook for 75% of the value of the property they are lending against. If they were lending 95% of its value they would be more bothered about the price tag in my opinion and may even refuse to lend against it. This would result in lower selling prices and lower profits for housebuilders.

Despite my views, housebuilders continue to prosper but there are signs that life is getting tougher for them despite all the help they are receiving.

This week's trading update from Barratt Developments was reasonably reassuring. Pre-tax profits for the year ending June 30th will be slightly better than analysts were expecting at £835m with the company's net cash position also a little bit better than expected.

Yet there are signs that trading could be about as good as it is likely to be for the current housing market cycle. Barratt sold 184 more homes than last year (17,579 vs 17,395) but benefitted from a 5% increase in average selling prices (ASPs) to £289,000. Private ASPs increased by 5.1% to £329k due to mix improvements (more bigger homes) and house price inflation. Profit margins have also improved slightly.

Current trading is reasonable with 10,155 units forward sold at the end of the year with a value of £2.18bn compared with 9,762 units and a value of £2.14bn a year ago. I'm not sure what to make of this as the value per unit has fallen slightly which suggests that it might be becoming harder for Barratt to grow the value of its sales and profits going forward.

Barratt Developments PLC (BDEV)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	4,866.5	+4.7%	4,971.0	+2.1%	5,051.0	+1.6%
EBITDA	853.7	+3.3%	882.1	+3.3%	924.1	+4.8%
EBIT	844.1	+2.6%	879.2	+4.2%	925.8	+5.3%
Pre-tax profit	817.4	+5.4%	851.7	+4.2%	894.6	+5.0%
Post-tax profit	659.5	+5.7%	683.6	+3.7%	722.6	+5.7%
EPS (p)	64.8	+5.4%	68.0	+4.9%	71.7	+5.4%
Dividend (p)	43.4	+77.9%	44.7	+3.0%	45.7	+2.2%
CAPEX	5.2	+29.4%	6.0	+15.0%	7.2	+21.4%
Free cash flow	309.0	-34.6%	554.3	+79.4%	575.2	+3.8%
Net borrowing	-550.7		-673.6		-836.7	
NAV	3,653.4	-15.3%	3,911.4	+7.1%	4,196.9	+7.3%

Despite my bearish view of the sector, I think Barratt shares are looking more attractive than they have done for a while after falling by 24% since the start of the year. At 493p they trade on 1.35 times their current tangible net asset value. A forecast return on tangible equity of 17.8% would suggest a P/NTAV of around 1.8 times if current profits were sustainable. This suggests to me that the market is already pricing in a more difficult outlook for Barratt.

I have my doubts that the current level of house prices is sustainable but if they are then Barratt shares do not look ridiculously expensive. They are also promising to pay very chunky levels of income to shareholders and offer a prospective dividend yield of 9% at the current share price.

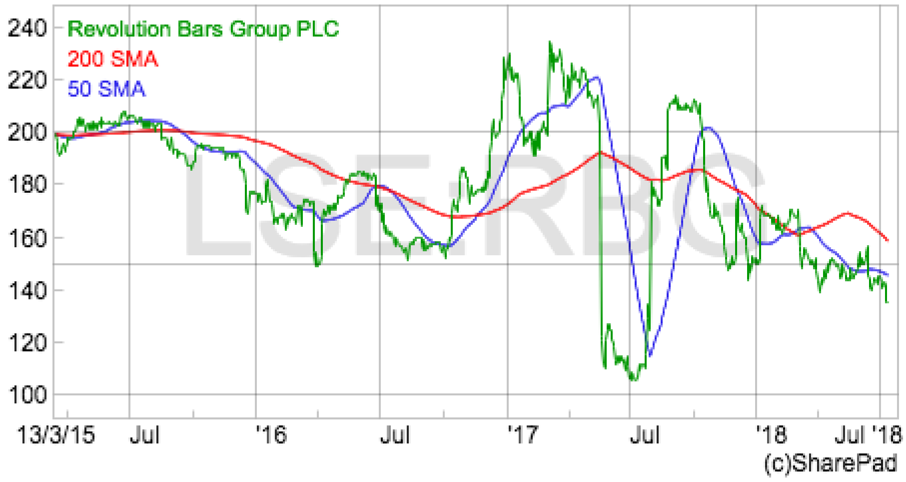
Some good news for pub companies

It shouldn't be surprising that the recent hot weather has led to more of us going to the pub for a drink. Yet, as with the recent patterns of trading in the sector, this boost to trading does not seem to be benefitting all pub companies equally.

This week we have seen trading updates from Young & Co's (LSE:YNGA) and JD Wetherspoon (LSE:JDW) two of the more proficient companies in the sector. Both said that LFL sales were up by 5.2% for the last 13 weeks and 10 weeks respectively. This is a good performance and should go a long way to helping both companies mitigate the big cost pressures that they face. However, maintaining this rate of sales growth for the rest of the year is likely to be a touch challenge.

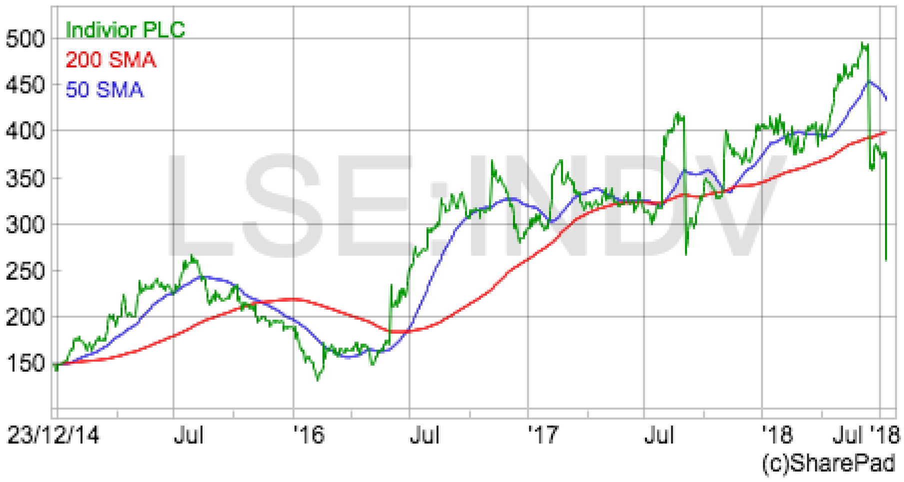
A rising tide does not seem to lift all boats in this sector. Greene King (LSE:GNK), Mitchells & Butlers (LSE:MAB) and Revolution Bars (LSE:RBG) have seen their share prices fall during the last month, with Revolution's falling by more than 11%.

I'm not a fan of Revolution's Cuban bars as I think that the format has limited appeal and scalability to make good money. I also don't like its leasehold model which has left it trapped in some very poor trading locations.



That said, I think the depressed share price makes this share quite interesting at the moment. A new chief executive will be under pressure to do something radical with the business fairly quickly which could possibly put it on the path to a better future. It is the prospect of radical restructuring rather than an upturn in current trading that holds the key to a materially higher share price in my view.

Indivior (LSE:INDV)



Indivior was spun off from Reckitt Benckiser at the end of 2014. For any investor familiar with the business at that time they would have been aware of the significant risk from the loss of patent protection for its key product – Suboxone.

Suboxone is a film used to treat adults who are addicted to opioids and has been a very lucrative product for Indivior. I must admit to being quite surprised as to how well Indivior's share price has performed in recent years given the risk from generic competition to Suboxone.

Now it seems that the chickens have come home to roost. Wednesday this week saw the company announce a profit warning due to a significant recent loss of market share of Suboxone due to a generic competitor – Dr Reddy's Laboratories – offering prices for its drug that are 75% to 80% lower.

On top of this bad news, Indivior announced that its replacement opioid injection product Sublocade was experiencing disappointing sales. Instead of selling $75m-$100m of the product in 2018, it now expects sales to be $50m lower which is quite a big shortfall to say the least.

The company is in a state of uncertainty and cannot even give profits guidance to investors:

"At this time, Indivior cannot reliably provide updated FY 2018 net revenue and adjusted net income guidance until the impact of DRL's launch is better understood. The Company expects that this will be no later than its third quarter results announcement, currently scheduled for November 1st."

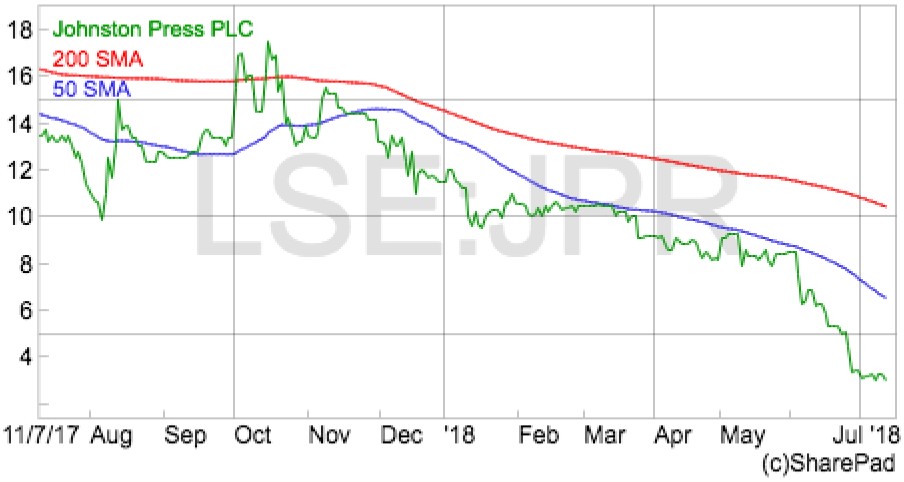
Unsurprisingly, the shares have fallen heavily on this news. I might be being harsh but I can't help feeling that the risks of investing in this company have been ignored and that some analysts and investors have been a bit complacent regarding them.

Indivior PLC (INDV)

FORECASTS — $ millions unless stated

Year	2018		2019		2020	
Turnover	1,006.3	-7.9%	957.7	-4.8%	1,136.2	+18.6%
EBITDA	334.2	+66.3%	339.6	+1.6%	472.9	+39.2%
EBIT	309.9	+64.8%	327.4	+5.7%	373.8	+14.2%
Pre-tax profit	354.1	+134.5%	310.2	-12.4%	317.1	+2.2%
Post-tax profit	267.4	+285.6%	250.8	-6.2%	254.6	+1.5%
EPS (¢)	38.3	+303.2%	36.4	-5.0%	42.3	+16.2%
Dividend (p)	-		-		-	
CAPEX	24.0	-44.3%	23.2	-3.1%	24.3	+4.6%
Free cash flow	240.2	-6.6%	202.0	-15.9%	357.9	+77.1%
Net borrowing	-554.5		-785.8		-1,059.2	
NAV	3.0		298.9	+9700.0%	654.2	+118.9%

Johnston Press (LSE:JPR)



The challenges facing the newspaper industry are well known. Fewer people are buying newspapers but they remain saddled with significant costs and liabilities such as pension deficits. Despite having some decent newspaper titles such as The Scotsman and The Yorkshire Post, Johnston Press has been overwhelmed by its inability to make enough money to stay afloat.

For some time, the company's ability to survive has hinged on its ability to repay a £220m bond that is due to mature in June 2019 or to get bondholders to take a big haircut. Given the current market capitalisation of just £3.5m, it seems that Johnston Press' days are numbered as far as its shareholders are concerned. This is a very sad state of affairs but it contains a valuable lesson for investors: declining businesses with lots of debt are a lethal mix.