Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

12th January 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7762.94	▲0.871	▲4.15	▲6.48	7762.94	7099.15	11/1/18	31/1/17
FTSE 250	20737.9	▼-0.396	▲3.36	▲12.7	20932.6	18081.8	5/1/18	30/1/17
FTSE SmallCap	6020.46	▲1.21	▲4.75	▲14.3	6020.46	5207.06	11/1/18	31/1/17
FTSE AIM 100	5463.15	▼-0.765	▲4.54	▲31	5506.5	4158.67	5/1/18	23/1/17
FTSE All-Share	4258.09	▲0.676	▲4.04	▲7.75	4258.09	3858.26	11/1/18	31/1/17
S&P 500	2748.23	▲0.89	▲3.32	▲20.8	2751.29	2263.69	9/1/18	19/1/17
Brent Oil Spot $	$69.085	▲1.63	▲6.7	▲24.9	$69.17	$44.785	9/1/18	21/6/17
Gold Spot $ per oz	$1317.87	▼-0.243	▲6.03	▲10.4	$1349.10	$1188.45	7/9/17	26/1/17
GBP/USD - US Dollar per British Pound	1.35378	▼-0.103	▲1.43	▲10.9	1.35945	1.20401	2/1/18	16/1/17
GBP/EUR - Euros per British Pound	1.1249	▲0.16	▼-0.75	▼-2.39	1.1972	1.0795	18/4/17	29/8/17

Top Risers

No.	TIDM	Name	%chg 1w
1	AO.	AO World PLC	▲23
2	PMO	Premier Oil PLC	▲19.3
3	PAGE	PageGroup PLC	▲17.7
4	CLLN	Carillion PLC	▲14.9
5	FENR	Fenner PLC	▲13.6
6	DIA	Dialight PLC	▲13.4
7	PRTC	Puretech Health PLC	▲11.9
8	PRV	Porvair PLC	▲11.7
9	CARR	Carr's Group PLC	▲11.7
10	TPT	Topps Tiles PLC	▲11.7

Top Fallers

No.	TIDM	Name	%chg 1w
1	MTC	Mothercare PLC	▼-22.1
2	CARD	Card Factory PLC	▼-21.2
3	MCB	McBride PLC	▼-20.4
4	MOSB	Moss Bros Group PLC	▼-15.4
5	SDRY	Superdry PLC	▼-12.4
6	MCRO	Micro Focus International PLC	▼-10.7
7	HIK	Hikma Pharmaceuticals PLC	▼-8.7
8	QQ.	QinetiQ Group PLC	▼-8.55
9	SSPG	SSP Group PLC	▼-8.24
10	GNK	Greene King PLC	▼-8.1

Elegant Hotels (LSE:EHG, Mcap £80m)

Elegant Hotels is an owner and operator of seven upmarket hotels in Barbados. It also has a contract to manage another hotel in St Lucia and a posh restaurant on Barbados called Daphne's. You can read my recent in-depth analysis of the company here.

I think it's fair to say that the company owns some decent assets in a nice part of the world. Not so long ago, that would have been a recipe for relatively stable and growing profits as wealthy UK customers sought an upmarket destination to soak up the sun in the winter time.

Sadly for Elegant this has not proven to be the case over the last year or so. The devaluation in the pound has made it more expensive for UK holidaymakers to visit Barbados. Whilst visitors to the island were up by 6.4% between January and October 2017, UK visitors only increased by 0.7%.

And fewer of them were staying at Elegant's hotels as there has been a shift towards villas and the value end of the market. This fed through to lower profits and a dividend cut for 2017 - a risk I flagged up in my earlier analysis - and another reduction flagged up for 2018. Unsurprisingly, the share price did not react well to this news and fell by just over 6% on the day of the full year results.

The company has recently attracted some takeover interest from Melia Hotels but that has ended. It's now down to the existing management team to get profits growing again.

But how easy is that going to be? With the UK customer market difficult at the moment, the pressure is on to woo more American customers.

Group Hotels	2014	2015	H1 2016	H2 2016	2016	H1	H2	2017
Occupancy	68.9%	68.4%	69%	56.8%	62.9%	66%	61.8%	63.9%
Daily room rate $	353	373	464	292	378	425	283	354
% change		**5.7%**			**1.3%**	**-8.4%**	**-3.1%**	**-6.3%**
REVPAR $	243	255	320	166	238	281	175	226
% change		**4.9%**			**-6.8%**	**-12.4%**	**5.4%**	**-4.9%**

One of the most closely watched performance indicators for hotels are how full they are (occupancy) and how much is charged per day (room rate). Multiply these two measures together and you get something known as the *revenue per available room* or REVPAR for short.

There is clearly a trade-off between occupancy and room rates and getting the balance right is a necessary skill of a competent hotel operator.

Elegant is in a seasonal business when most of its money is made in the winter months between December and March. What we can see is that over the last year or so, the company has been cutting its room rate and that REVPAR has fallen.

However, if my estimates are correct then things may actually be turning around. It looks as if the decline in room rates has moderated somewhat during the second half of 2017 and occupancy has improved leading to an improvement in second half REVPAR.

The key test will be how trading is shaping up for the key winter months. The company says that bookings are ahead of last year but the devil is in the detail. What I find interesting is that the company has decided not to cut prices at its most upmarket hotels, The House and Colony Club. It seems to want to preserve their premium image by keeping them reassuringly expensive. Time will tell if this has been the right thing to do.

What is encouraging is that the company is having some success with hotels it has bought and improved. The Waves hotel has the highest occupancy in the group at 73% which has been achieved with higher room rates than before it was bought.

The Treasure Beach was an underperforming hotel bought by Elegant and is part of the company's refurbish, reposition and reprice strategy. It has had $2.8m spent on it and reopened in December 2017. This should make a useful contribution to profits going forward.

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	48.0	+7.7%	49.9	+4.0%	51.1	+2.3%
EBITDA	14.7	+10.0%	15.6	+6.4%	16.1	+3.2%
EBIT	11.4	+10.8%	12.2	+7.3%	12.8	+4.7%
Pre-tax profit	9.3	+9.2%	10.2	+8.9%	10.8	+5.8%
Post-tax profit	-		7.8		-	
EPS (p)	8.1	-5.0%	8.8	+8.2%	9.3	+5.9%
Dividend (p)	4.1	-22.6%	4.1	+1.8%	3.5	-14.3%
CAPEX	3.0	-28.2%	3.0	+0.8%	2.4	-18.9%
Free cash flow	7.7	+134.3%	8.7	+12.4%	9.0	+3.8%
Net borrowing	52.0	-4.5%	49.1	-5.4%	47.6	-3.1%
NAV	88.0	+7.7%	91.9	+4.4%	95.9	+4.3%

Forecasts are for some modest growth but note the consensus is currently factoring in another dividend cut in 2020.

The key issue is whether all the potential bad news is priced into the shares.

NAV per share based on the September 2017 balance sheet and $/£ exchange rate of 1.34 is 92.2p which is not far off the current share price at the time of writing. Management regularly refer to a much higher implied NAV per share of 163p per share but I think this is far too optimistic.

The bulk of this valuation is based on a report by professional property experts CBRE in 2015 which assumed much higher room rates and occupancy levels than are currently being achieved.

I think it is too optimistic given the return someone would get on paying 163p per share. They would get back 8.1p of EPS in 2018 which equates to a return on equity

of 5%. Personally, I'd want at least double that to consider investing with the prospect of growth on top. So either profits have to grow very rapidly or the valuation of the shares has to be lower.

This leads me to think that the shares are reasonably valued at the moment but are not desperately cheap.

I was having an interesting and civilised chat with @marben100 on Twitter about the valuation of Elegant Hotels earlier in the week. He referred me to a chat he had in the past with someone in the trade about how to value hotels and mentioned that they are valued on multiples of EBITDA rather than asset values.

That may be the case but asset values are arrived at on the basis of future profits. The problem I have with EBITDA is that it is not representative of the money that would end up in your pocket if you owned a hotel. You have to spend money on hotels to keep them looking nice so that customers keep coming through the doors. This is certainly the case with the upmarket hotels that Elegant owns.

In fact, one of the reasons that Elegant has cut its dividend is that it needs cash to reinvest in its hotels.

*"Given the current market opportunities **and the need to reinvest in our properties in an increasingly competitive market,** the Board is recommending a reduction in our final dividend to 1.75p for the year ended 30 September 2017 from 3.5p in the prior year."*

I would therefore argue that using EBITDA multiples to value hotels is perhaps not the right way to go about it.

Superdry (LSE:SDRY, MCap £1.6bn)

The management of Superdry are trying to turn the company into a prominent global clothing brand. They sell what is known as 'athleisure' clothing - the kind of stuff you can play some sport or outdoor activity in but also perhaps wear down the local pub as well.

(Disclosure: Phil Oakley currently owns shares in Superdry)

The brand has traditionally been popular with young people - with t-shirts, jackets and hoodies - and has had the endorsement of famous wearers such as Kate Moss and David Beckham in the past. One of the company's aims is to get youngsters to stay with the brand as they get older.

It has not all been plain-sailing for the company which floated on the stock exchange in 2010. A series of profit warnings in 2012 decimated the share price and served as a stark reminder to investors that fashion is a fickle business and brands can very quickly become tired and out of date. This is undoubtedly the main - and real - risk that shareholders in this company face.

Superdry sells its clothes through a network of over 600 shops (233 company-owned and 372 franchises), wholesale to other retailers, and over the internet. The business has been growing nicely over the last few years.

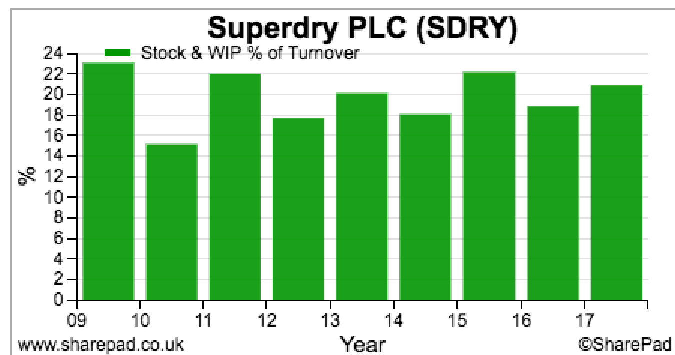
Wednesday’s half year results looked alright with sales and pre-tax profits up by just over 20%. Wholesale revenues increased by 34% with retail sales increasing by 12.8%. Internet sales grew by 31.6% and now represent 25.2% (21.6%) of retail revenue.

Yet the company’s shares sold off sharply as analysts and investors took a dim view of the company’s trading over the key Christmas period and the fact that profit margins have come down.

What seems to have spooked people is the performance of the company’s retail stores. A year ago, same store sales were growing at 13.7% but that has slowed to just 3.7% during the second quarter.

In the 10 weeks to 6 January 2018, retail like-for-like (LFL) sales growth was slightly improved at 4.7% yet it seems after trawling the internet that the company, when chatting with some City analysts, suggested that trading over Christmas in its owned retail stores was negative and the trend had worsened. There is no mention of this in the trading update so there is no way of private investors knowing if this is indeed the case. But it would explain the sharp sell-off in the shares.

Bears are also pointing to lower gross margins (57.1% versus 58.8%) but operating margins for the first half actually increased slightly from 6.6% to 6.7%. The company has not increased selling prices whilst selling off excess stocks has reduced gross margins.



One of my chief concerns about Superdry is the amount of stock that it tends to operate with. Product availability is important but having too much stock means there is a risk that prices might have to be slashed to get rid of it which could blow a big hole in profits.

TIDM	Name	Stock to turnover
SDRY	Superdry PLC	20.9
ASC	ASOS PLC	16.8
BOO	boohoo.com PLC	11.6
NXT	Next PLC	11.0

Superdry has around 20% of its sales in stock which is pretty high - certainly higher than other clothing retailers. Whilst it is true that Superdry is not just a retailer, it does outsource the

manufacture of its products to external suppliers and therefore should not naturally be holding huge amounts of stock.

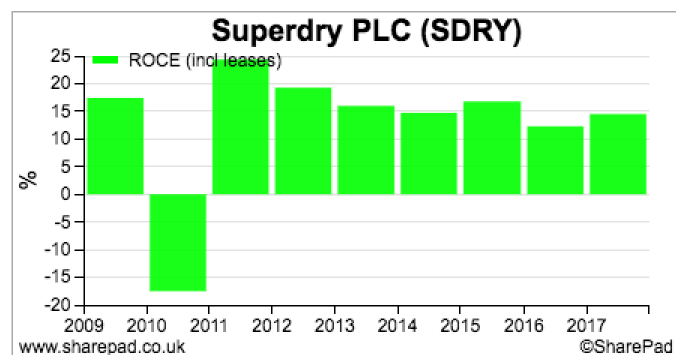
Management are trying to do something about this which it needs to in my opinion.

But is it all doom and gloom for Superdry as Wednesday's share price seems to suggest? It would be foolish to ignore that there aren't risks in a fickle fashion-based company such as this.

That said, the company seems to be making good progress in e-commerce and wholesaling whilst pushing on with expansion plans in key markets such as the USA or China. It is launching a new range of premium jackets and targeting the womenswear market where it is not selling as much as it potentially could do.

The company also seems to have a balanced way of selling its stores in order to cope with a changing retail market. For example, its stores strategy is to own them in prime locations to benefit from the trading opportunities and to franchise them - and so pass on more of the risks to franchisers - elsewhere. This makes a lot of sense in my opinion.

The business can become more efficient with better stock control and more direct sourcing with suppliers. Yet, this is not a bad business at all as evidenced by it making a ROCE of nearly 15% last year.



Profits are currently expected to be in line with expectations and the lack of an upgrade may also explain the share price reaction given that the shares are no bargain on more than 19x forecast EPS at a share price of 1860p.

We are clearly in a stock market environment where richly priced shares have to be doing better than people were expecting in order to keep share prices moving higher. Any disappointments or doubts are treated harshly.

Next (LSE:NXT, Market cap £7.3bn)

For a long time, Next has possessed a lot of the sought-after characteristics of a great business in the form of high profit margins, high ROCE and great free cash flow generation. The missing ingredient for the last year or so has been profits growth. In fact, the concern has been whether Next will become a shrinking business.

Last week's trading update brought reassuring news that Next's profits for 2017 will be better than had been previously expected. This led to a relief rally in the shares but the truth of the matter is that Next's profits are still falling.

Underlying pre-tax profit to January 2017 was just over £790m and will be around £725m in the year to January 2018.

Full Year Estimate	New Central Guidance	Previous Central Guidance
Year to January 2018 (52 week basis)		
Total full price sales versus 2016/17 (inc currency gain)	+0.3%	− 0.3%
Group profit before tax	GBP725m	GBP717m
Group profit before tax versus 2016/17	− 8.3%	− 9.3%
Earnings Per Share growth versus 2016/17	− 5.7%	− 6.8%

It is then expected to fall again to around £705m in the year to January 2019.

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Full Year Estimate                   Central
                                     Guidance
                                   ==========
 Year to January 2019 (52
  week basis)
================================   ==========
 Total full price sales versus
  2017/18                               +1.0%
 Group profit before tax              GBP705m
 Group profit before tax versus
  2017/18                              - 2.8%
 Earnings Per Share growth
  versus 2017/18                        +1.1%
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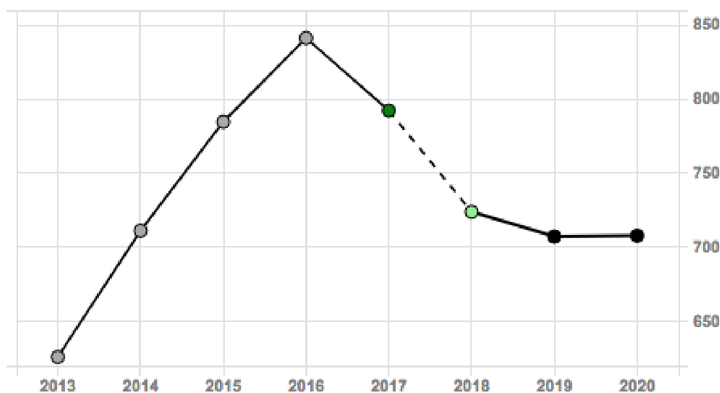
If we then look at the consensus of City analysts' forecasts, profits are then expected to be flat the year after.

Next PLC (NXT)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	4,113.3	+0.4%	4,150.1	+0.9%	4,201.6	+1.2%
EBITDA	875.7	-7.3%	860.5	-1.7%	858.4	-0.2%
EBIT	758.1	-8.6%	741.9	-2.1%	739.6	-0.3%
Pre-tax profit	723.9	-8.6%	707.2	-2.3%	707.8	+0.1%
Post-tax profit	592.0	-7.1%	575.3	-2.8%	577.0	+0.3%
EPS (p)	409.3	-6.9%	407.2	-0.5%	419.2	+2.9%
Dividend (p)	158.0	0.0%	167.5	+6.0%	163.8	-2.2%
CAPEX	125.4	-20.1%	129.9	+3.6%	130.8	+0.7%
Free cash flow	548.8	+7.4%	535.3	-2.5%	549.9	+2.7%
Net borrowing	868.2	-3.4%	836.6	-3.6%	787.2	-5.9%
NAV	425.0	-16.8%	455.3	+7.1%	483.7	+6.2%
Like for like sales growth %	-9.2		-5.8	-36.7%	-4.2	-27.6%

PRE-TAX PROFIT £



Shows the previous 5 full year actual results and the next 3 full year forecasts.

So what is there to like about Next shares at a current share price of just over £50?

Full Price Sales (VAT exclusive)	54 days to 24 Dec	Year to 24 Dec
Retail	- 6.1%	- 7.2%
Online	+13.6%	+10.4%
Brand Total	+1.5%	+ 0.2%
Of which sales from new space	1.1%	1.3%

Well, looking at Next as a company with two businesses is probably a good place to start. Selling stuff on the high street is going to remain a tough place to make money with sales declining and all the associated overhead including store costs and rents.

I think it should be fairly safe to say that Next will be shrinking its high street presence over the next few years and not renewing lease agreements when they expire.

What it does have is a fast growing and increasingly valuable online business in the form of Next Directory that may be able to offset the declining value from its retail stores. Online is where the value is in retailing. I have no doubt that if Next Directory was a separately listed business that it could command a very high stock market valuation. Yet again it has grown at a very decent rate over the Christmas period (+13.6%) and over the year as a whole (+10.4%). A couple of years ago, the profits of the online business exceeded the retail business for the first time.

1. Segmental Analysis (continued)

Segment profit	52 weeks to 28 January 2017 £m	52 weeks to 23 January 2016 £m	53 weeks to 30 January 2016 £m
NEXT Retail	338.7	402.1	408.1
NEXT Directory	444.1	405.2	413.3
NEXT International Retail	9.3	10.2	10.4
NEXT Sourcing	44.7	50.5	51.1
	836.8	868.0	882.9

What I find fascinating about Next is how it can sustain very high profit margins compared with other clothing and homeware retailers.

Last year, Next retail made profit margins of 15.4% with Next Directory making a staggering 26.2%. In the notes to the annual accounts we can see that Next receives £213.7m of interest income from Directory account customers (at an average rate of over 22%).

TIDM	Name	EBIT margin
NXT	Next PLC	20.3
SDRY	Superdry PLC	11.4
DNLM	Dunelm Group PLC	10.9
BOO	boohoo.com PLC	10.2
ASC	ASOS PLC	4.2

2. Revenue by Type

	2017 £m	2016 £m
Sale of goods	3,866.0	3,966.8
Directory account interest	213.7	192.5
Royalties	9.9	10.8
Rental income	7.7	6.8
Revenue	4,097.3	4,176.9

Let's see what would happen to Next's Directory and overall profit margins if this interest income did not exist. To keep things simple, I am assuming that the interest income is pure profit but it is likely there will be some costs against it.

2017 £m	**Next plc**	**Directory**
Sales	4,097.3	1,694.4
Directory Interest	-213.7	-213.7
Adjusted Sales	**3,883.6**	**1,480.7**
Trading profit	826.1	444.1
Directory interest	-213.7	-213.7
Adjusted Profit	**612.4**	**230.4**
Adj. margin	**15.8%**	**15.6%**
Reported margin	**20.2%**	**26.2%**

On this basis, Directory interest accounts for over a quarter of Next's trading profit, nearly half of Directory's profits and has a big impact on profit margins. Having said this, even when the effect of interest is ignored Next's profit margins are still very respectable and could be seen as a sign that it is a very good business.

Alternatively, it could be interpreted that Next could be too profitable, that its margins are too high and that it could be vulnerable to competition.

Next is a very decent business but one that is struggling to grow. It continues to throw off considerable amounts of free cash flow which will be used to buy back shares and boost EPS. The company remains a role model for communicating with investors and the amount of transparency it gives them.

At 12 times forecast EPS and offering a 3.1% dividend yield the shares are reasonably valued in my view but are unlikely to take off in the absence of sustained profits growth.