

SHARES

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INVESTORS NEED
TO KNOW ABOUT:

**TESCO'S £3.7BN
BOOKER DEAL**

**VODAFONE'S
INDIAN
DEMERGER**

SLICK PICKS

**FOUR OIL FIRMS WITH
HOT PROSPECTS**

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WHEN TO INVEST

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Is this the last hurrah for UK GDP?

Rising household debt could put the brakes on consumer spending and the broader economy

Eight months ago the country was in a bad mood, worried about sinking into recession and fearing for the state of the UK economy following the Brexit vote.

Today we are still in that nervous period despite better than expected fourth quarter GDP figures and upbeat consumer confidence data.

Media headlines over the past few weeks have focused on an improvement in consumer confidence in January, with many people in GfK's latest survey (31 Jan) saying their personal finances are in healthy state.

Other headlines latched on to positive economic data, such as 'UK remains fastest growing economy in the western world' and 'UK manufacturing "firing on all cylinders".'

WHY WE AREN'T CELEBRATING

There are reasons to retain a more cautious stance and not get carried away by the headline-grabbing data points.

The fourth quarter GDP growth was dominated by the services sector, worth nearly 80% of the economy. However, there was minimal growth in the construction industry versus the previous quarter and no growth in the production sector at all.

The services sector is heavily exposed to consumer spending. Its constituents include retail, hotels, restaurants, entertainment and recreation – alongside transport, health and education and more.

Consumer spending is therefore crucial to propping up the UK economy.

GfK's latest survey shows that consumers



are feeling hopeful about their personal financial situations over the next 12 months. Is this a reason to be cheerful? We're not so sure.

We're concerned about rising personal debt levels and feel that consumers could be relying too much on debt rather than hard cash to fund their shopping sprees.

Have you noticed how easy it is to get a credit card offering 0% interest for up to two years? You'd be feeling confident about your finances if you could borrow money for free.

But what happens when the interest-free period expires? The credit backdrop may have changed in that two year period and lenders no longer offering alternative products with 0% rates.

HOUSEHOLD DEBT ALERT

Average household debt excluding mortgages stands at a record £13,000, claims the TUC. The Bank of England's latest Money and Credit report showed consumer credit grew by £1.9bn in November. The 12-month annual growth rate in consumer credit now stands at 10.8%, the highest level since October 2005.

I foresee a squeeze on household spending as a result of rising inflation and uncertain economic conditions potentially curbing decent wage growth.

People may feel comfortable about their finances now, but the story could be very different in a year's time if rising interest rates put pressure on the ability to service debt repayments.



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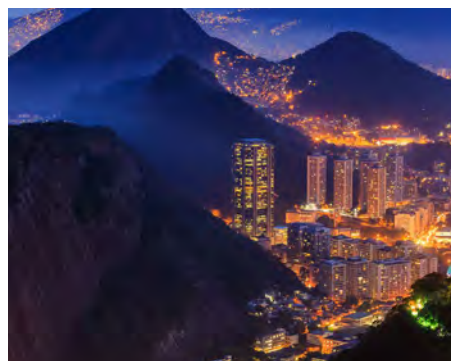
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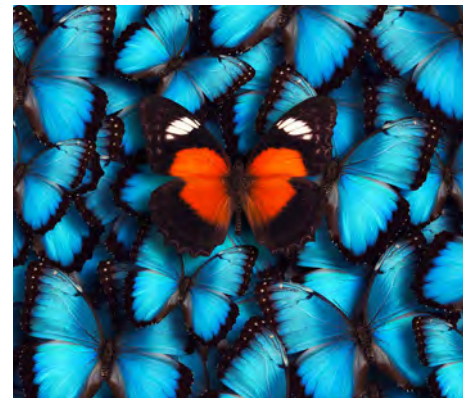


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DISCLAIMER

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We like Tesco's £3.7bn plan to buy Booker

But some experts have their doubts

Supermarket **Tesco (TSCO)** gets our vote for its share and cash takeover of food wholesaler **Booker (BOK)**.

There is much to like about the premium-priced £3.7bn deal, although it introduces execution risk into the Tesco narrative and will come under scrutiny from the UK Competition & Markets Authority (CMA). If the deal goes through Tesco will become both a dominant food industry supplier and undisputed leader in the convenience retail sector.

DIVIDENDS BACK ON THE MENU

Chief executive officer Dave Lewis heralded Tesco's intention to resume dividend payments alongside the takeover news.

Lewis believes the enlarged group will be well placed to serve the large, established 'in home' food market and the faster growing 'out of home' food market and has identified £200m of annual cost benefits.

Tesco and Booker both operate in mature markets. AJ Bell Investment Director Russ Mould suspects there is an idea to create growth where little exists, 'even if Tesco boss Dave Lewis and his equivalent at Booker Charles Wilson would doubtless argue the deal will augment gathering

momentum in the two separate businesses.'

On the plus side, the Booker deal brings diversification through a move into domestic wholesale and opportunity to supply the target's convenience stores with Tesco's own label products.

Shore Capital analyst Clive Black is surprised by the mooted merger, saying it represents a considerable volte face in strategic direction by both companies. 'Elements of Bookers' shareholder base may feel that a relatively pure-play cash rich, cash generative and high yielding organisation, meriting a premium equity multiple rating, will effectively be subsumed and polluted through its absorption by Tesco,' he comments.

Reiterating his 'hold' rating on Tesco, Black adds 'Perhaps the most interesting question is what does the proposed merger mean for Booker and its shareholders?

'In a nutshell we believe that it is the end of the Booker that we have admired for some years.

'Accordingly, for investors who wanted a stake in an excellent management team, strengthening market positions in its respective segments and so driving strong free cash generation to sustain an ongoing programme of ordinary and special dividends, then the road is coming to an end in its 2018 financial year.'



Vodafone's answer to India price wars

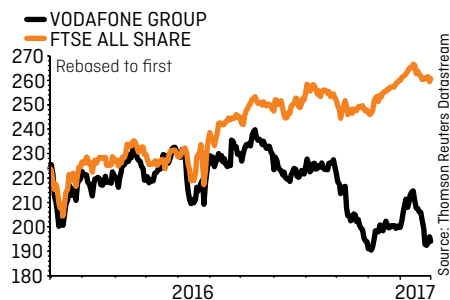
Merger talks could blunt competition thorn

Vodafone (VOD) is in talks that could see it merge its Indian business with local rival Idea Cellular. Investors hope that a tie-up could ease the pressure of an intense price war that has broken out in the Asian state, where a billion-plus mobile subscribers are up for grabs.

The current savage battle for market share has been sparked by **Reliance Industries (RELI:NS)**-backed Jio, a new entrant to the Indian mobile market that has been offering free nationwide voice and 4G data since September 2016. As *Shares* explained last week (26 January 2017), this has forced other telcos to drastically cut prices in order to remain competitive.

Presumably, Vodafone hopes that a tie-up with Idea Cellular will be a decisive mobile subscriber landgrab. It would create a new market leader in India with approximately 387m mobile customers, according to figures from the Telecom Regulatory Authority of India (TRAI). Current leader Bharti Airtel has 262m.

Analysts at broker Jefferies welcomed the



possible merger news with 'cautious optimism,' potentially stabilising the competitive landscape in India and

maybe removing a friction point with regulators if Vodafone was to pursue a mooted merger with **Liberty Global (LBTYA:NDQ)**, the US owner of Virgin Media. On the negative side, Jefferies also flags the possibility that Vodafone may need to raise around €3bn of new funding to help deleverage any new Indian joint venture.

SHARES SAYS: ↗

We continue to like Vodafone's income yield, now at 6.6% based on a 194p share price.

BROKER SAYS **15** **9** **3**

Value expedition for new Polar fund

INVESTMENT MANAGER Polar Capital (POLR:AIM) has launched the UK Value Opportunities Fund, which will scout for undervalued large, mid and small caps temporarily trading below intrinsic value. The fund will be managed by Georgina Hamilton, whose resignation from **Miton (MGR:AIM)** in April last year clobbered the share price, alongside her former Miton colleague George Godber. (JC)

Redcentric's new business cheer

EMBATTLED IT and communications services supplier **Redcentric (RCN:AIM)** appears to be putting its accounting disaster behind it. The company has won an approved supplier spot on the new Health and Social Care Network, part of the NHS Digital shift. Added to the recent contract with bed maker Silentnight, new business opportunities do not seem to have been substantially dented. The shares trade at 96.25p. (SF)

Gambler's profits at stake

BOOKIES Ladbrokes Coral (LCL), Paddy Power Betfair (PPB) and William Hill (WMH) shrugged off a renewed call (31 Jan) from the all-party parliamentary group for a £2 staking limit on fixed-odds betting terminals. The report's findings were leaked in December. Broker Davy argues that 'while the calls for a £2 staking limit worry shareholders in William Hill and Ladbrokes Coral, we believe such an outcome is unlikely'. (JC)

Energise your portfolio with Science in Sport

Sports nutrition products maker is a momentum and M&A trade

Pocket sports nutrition products manufacturer **Science in Sport (SIS:AIM)** ahead of next month's (23 Mar) full year results statement, where a positive outlook could give the shares another energy boost.

With revenues sprinting higher and awareness of its 'SiS' brand growing in a \$10bn global sports nutrition market, *Shares* expects news flow to remain positive and believes a premium priced takeover bid shouldn't be ruled out.

GOING FOR GOLD

Hatton-headquartered Science in Sport makes and markets sports nutrition products for pro athletes and amateurs alike. Its science-backed SiS brand of energy powers, isotonic gels, energy bars and protein-based recovery powders has growing traction with elite athletes.

In the 2016 Rio Olympics, 34 medal-winning teams or athletes used its products, up from 24 in 2012 – Science in Sport's rigorous approach to preventing banned substances from entering its supply chain only engenders trust.

The official sports nutrition supplier to professional cycling teams Team SKY, British Cycling and to USA Cycling, Science in Sport is also the official sports nutrition partner to Liverpool FC. Olympians Sir Chris Hoy MBE and Katarina Johnson Thompson are Brand Ambassadors, while Mark Cavendish is an Elite Sports Consultant to the brand.

FIGHTING FIT

The £36.4m cap operates in a resilient market driven by the burgeoning popularity of endurance sports. Encouragingly, Science in Sport has positive news flow momentum at its heels.

A pre-close trading update (5 Jan) highlighted 30% sales growth to £12.24m in the full year to December, direct sales via scienceinsport.com doubled year-on-year. Moon also flagged 'healthy distribution gains' with independent retailers and



'robust growth' with supermarkets and via third party online retailers.

International markets are a key focus. Science in Sport's new Australian operation is performing ahead of expectations and the US and Italy are very much a focus for 2017. Sterling depreciation represents a headwind in terms of sourcing costs, yet gross margins reportedly improved in the final quarter as production efficiencies at the Nelson factor 'reached new highs' during 2016.

Admittedly, Science in Sport remains loss-making as it invests for growth. It also has a strong balance sheet and improving gross margins indicate management control of costs.

This is enabling the investment in marketing necessary to underpin the prospects of a brand and expanding product portfolio sure to be on the radar of deep-pocketed suitors. Industry M&A activity has been strong, with high-profile acquirers in the sector including **GlaxoSmithKline (GSK)** and larger nutrition peer **Glanbia (GLB)**.

SHARES SAYS: ↗

Science in Sport has top line momentum and we're staying positive on the micro cap at 83.26p. (JC)



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Companies presenting

Guinness Asset Management Ltd Tim Guinness, CEO

Guinness is independent and focused purely on investment management. Our in-house economic, industry and company research allows us to take an independent view and not be led by the market. Our size and specialist nature also means we have the ability to respond quickly and efficiently to any market movements.

Versarien plc (VRS) Neill Ricketts, CEO

Founded in 2010, Versarien utilises proprietary technology to create innovative new engineering solutions that are capable of having a game-changing impact on a broad variety of industry sectors. Versarien plc's (VRS) impact on the graphene space continues - as it won a significant £100,000 order to supply high quality material to an unnamed European commercial customer.

Allianz Technology Trust PLC (ATT) Walter Price CFA, Portfolio Manager

ATT is managed by Walter Price who is a Managing Director and Portfolio Manager on the AllianzGI Technology Team in San Francisco, having joined in 1974. Walter is a current Director and past president of the M.I.T. Club of Northern California. He also heads the Educational Council for M.I.T. in the Bay Area and is a past Chairman of the AIMR Committee on Corporate Reporting for the computer and electronics industries.

SHARES are also going back to EDINBURGH for another important and interesting investor evening. With 5 exciting companies presenting on the 15th at The RADISSON BLU Hotel in the city centre.

For full details please follow [this link](#)

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Presentations to start at 18:30

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NUMBER OF ADULTS IN EUROPE CLASSED AS OBESE

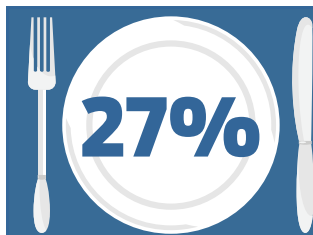
OBEISITY IS BECOMING an increasingly big issue for governments and businesses.

In Europe, 15.9% of people over the age of 18 are classified as obese.

Scotland is considering enforcing parking restrictions to get people to walk more, while France recently banned unlimited fizzy drinks in restaurants.

Life sciences business **Optibiotix (OPTI:AIM)** aims to capitalise on our over-indulgence by developing 'healthy' sugars that cannot be digested in the human gut, making them calorie-free.

It is working with food, wellbeing and pharmaceutical companies to bring its platforms to market.



Significant earnings downgrades YET AGAIN for Restaurant Group

ANALYSTS HAVE SLASHED 2017 earnings forecast for **Restaurant Group (RTN)** by an astonishing amount as turnaround efforts by the Frankie & Benny's and Garfunkel's operator have yet to make a positive impact.

Investec's pre-tax profit forecast is cut from £75.6m to £54.9m, equal to a 27%

downgrade.

Restaurant Group last summer announced plans to revise its menus; make operational changes; and improve its technology systems.

The latest trading update (25 Jan) revealed like-for-like sales fell 5.9% in the last three months of 2016. The shares fell 18% over the course of the week.

£47m Kromek's big take from shareholders



X-RAY TECHNOLOGY DEVELOPER **Kromek (KMK:AIM)** has raised £47m from investors since IPO on 16 October 2013. Sadly, progress has been slow going and the current market value of the business stands at £33.8m, substantially below the £55m capitalisation when joining AIM. The Durham University spin-out still hopes to grow the business into several markets using its own patent-protected Cadmium Zinc Telluride (CZT) crystal technology. Contracts have been won with homeland security agencies for its nuclear radiation detection kit and there are applications in airport security and medical imaging markets to address. (SF)

128.2 MILES

THIS IS HOW far the line would stretch if you laid down head to feet the 130,000 subscribers in India mobile phones apps store **Mobile Streams (MOS:AIM)** claims to have signed up. That's about 86% of the 150-odd miles

between Dehli and Jaipur, also known as India's 'Pink City.' The UK company has high hopes for Indian growth, but don't hold your breath. Efforts to crack US, Mexico, parts of Europe and Nigeria haven't gone well. (SF)



11% PURPLEBRICKS SHARES SURGE ON SOCIAL MEDIA REVEAL

THE SHARE PRICE of online estate agency **Purplebricks (PURP:AIM)** surged 11% after the company revealed a record January for valuations and instructions on Twitter (26 Jan) – but failed to tell shareholders via official news channels.

Embarrassingly the company issued a statement to the stock market more than 24 hours after the tweet, noting it was unaware of the reason for the advance in its shares.

Subsequently (30 Jan) the company clarified the revelation on social media was in line with expectations as year-on-year instruction growth had already been forecast.

5p per share

THE PRICE AT which new non-executive director Michael Butler agreed to subscribe for 2m new shares in cash-strapped mobile phones network **The People's Operator (TPOP:AIM)**, matching the level of the firm's recent £1.7m cash call. This represents a sickening, if unsurprising, collapse for investors considering that the company originally raised £20m at 130p per share when it joined the junior market on 4 December 2014. The company has also had to pay board members in discounted stock in order to conserve cash. (SF)

BEST PERFORMING FTSE 350 SECTOR INDICES OVER PAST 6 MONTHS

1	Mining
2	Industrial Metals
3	Banks
4	Oil Equipment & Services
5	Food & Drug Retailers
6	Automobiles & Parts
7	Construction & Materials
8	General Industrials
9	Industrial Engineering
10	Forestry & Paper

Source: Sharepad, data to 31 Jan 2017

WORST PERFORMING FTSE ALL-SHARE STOCKS YEAR TO DATE

St Ives	-41.4%
Pearson	-24.2%
Next	-22.9%
Inmarsat	-19.2%
BT	-16.9%
Pets at Home	-16.2%
Dunelm	-16.2%
Cobham	-16.0%
Premier Foods	-16.0%
Allied Minds	-15.5%

Source: Sharepad, data to 31 Jan 2017

'Double your money' with SDX Energy

Transaction delivers big increase in reserves, production and cash flow

Oil and gas producer **SDX Energy (SDX:AIM)** is on course for a step change in scale. The company has secured \$40m in an over-subscribed placing (27 Jan) to fund the acquisition of assets in Egypt and Morocco from financially distressed peer **Circle Oil (COP:AIM)**. Buy the shares at 38.23p.

Broker Cantor Fitzgerald believes the company will be worth 78p a share in a year's time, implying that investors could double their money.

WHY THE NEW DEAL IS IMPORTANT

The acquisition will boost SDX's output by 247% to 4,705 barrels of oil equivalent per day. Proved and probable reserves will increase by 64% to a little over 12m barrels of oil equivalent per day (boepd).

Cantor estimates the deal will pay for itself in a mere 16 months, based on current oil prices. It believes the acquisition will boost cash flow by \$22m in 2017 and by \$28m in 2018.

A QUARTER OF THE WAY TOWARDS THE BIG TARGET

Analyst Sam Wahab says: 'In terms of deal metrics, we believe SDX has secured a value accretive set of assets at a considerable discount to net present value, with an inferred acquisition price of \$6.40 per

SDX ENERGY BUY

(SDX:AIM) 38.23p

Stop loss: 25p

Market value: £31m



barrel of oil equivalent.'

SDX raised \$11m when it joined AIM in May 2016. At that time, chief executive Paul Welch told *Shares* about his plan to raise output to 20,000 boepd through exploration, development drilling and acquisitions.

Welch hinted SDX might put itself up for sale once that goal was achieved, flagging aspirations for a potential takeover in the region of \$850m and \$1.2bn.

The Circle Oil deal effectively gets SDX 25% of the way to Welch's 20,000 boepd target.

It incorporates a further 40% in the NW Gemsa concession

where SDX currently has a 10% working interest, in addition to two assets onshore Morocco.

IMPROVED INVESTMENT CASE

The move into Morocco improves the investment case as SDX no longer has a single country focus.

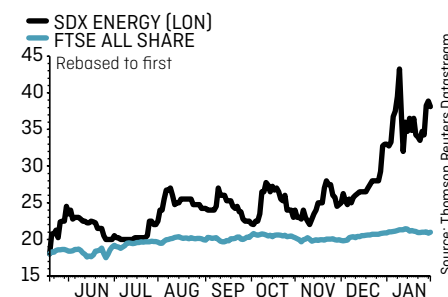
The transaction includes \$16m of receivables which is essentially cash owed to Circle by the Egyptian government.

Investors will need to keep an eye on SDX's ability to recover this money. Encouragingly it has had few problems with receivables in its existing business.

Although the company's focus is low-cost production there are also plans to drill an exploration well on the South Disouq licence. Scheduled for the first quarter of 2017, this will target 715bn cubic feet of gas net to the company's 55% interest.

The stock looks an absolute bargain at 38.23p, trading on a mere 1.9 times forecast earnings for the year to January 2018. Buy. (TS)

BROKER SAYS:



Satellite Solutions heads for the stars

Company on verge of maiden profit as it brings broadband to hard-to-reach places

Everybody needs fast broadband. The UK government demands 95% of the population enjoy a minimum of 24mbps (mega bits per second) by the end of this year. What about the other 5%, located in the relative backwoods of Britain? **Satellite Solutions Worldwide (SAT:AIM)** is part of a solution, not just here but across Europe, Scandinavia, Australia and elsewhere. The company reckons 15% of homes in Europe can't plug into copper or fibre networks.

GETTING ONLINE

The Bicester-based company buys satellite broadband and airtime and supplies homes, businesses, broadcasters, construction sites, even parts of the military, under its *Europasat* brand. It had roughly 75,000 customers across 32 countries at the last count in November 2016. That makes it the world's fourth largest operator in this market. The company hopes it will beat its own 100,000 subscriber target by November 2017.

Deals start at £9.99 a month and go up to £69.99 depending on your download allowance, all at 20mbps speeds.

Customers are acquired through direct channels, such as telesales and via its website, and through resellers which share part of the profit. But Satellite Solutions is also pulling

SATELLITE SOLUTIONS WORLDWIDE BUY

(SAT:AIM) 8.78p

Stop loss: 6.15p

Market value: £47m

off acquisitive growth by buying distributors whose customers can be migrated onto its own platform.

Viveole is the latest acquisition but it was last summer's triple-header (Avonline, Breiband and SkyMesh – the latter alongside a £12m cash call), that really ignited the company's potential.

Falling wholesale costs, a nightmare for operators, is great for Satellite Solutions. It provides flexibility to pass on lower costs during a marketing push, or keep prices firm to bolster profit margins. It should also help drag churn under control, which was running pretty high at 19% at the half year stage in 2016.

As the company scales up it can strengthen its position as an industry consolidator and with it gain leverage to get even better terms from satellite cluster operators, as has recently done through a new deal with a leading name in this space, SES.

MAIDEN PROFIT

The company is expected to unveil a maiden pre-tax profit when it reports full year results

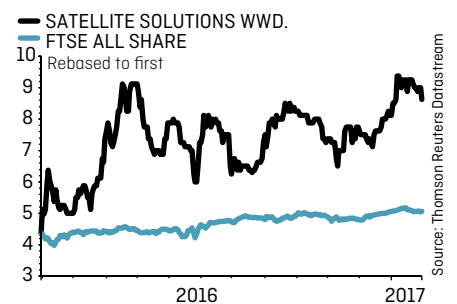
in March. Broker Arden Partners estimates pre-tax profit of £500,000 on £19.8 million of revenue.

The equivalent figures for 2017 come in at £3.4 million pre-tax profit on £38.1 million revenue, implying EPS (earnings per share) of 0.63p, or a price to earnings (PE) multiple of 14.3.

Management have decent stakes while star small cap tech fund manager Katie Potts is on board, as is property mogul Nick Candy. (SF)



BROKER SAYS: 1 0 0



DIAGEO

(DGE) £22.24

Gain to date: 2.3%

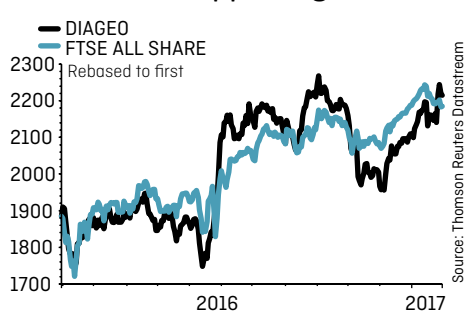
Original entry point:

Buy at £21.73, 12 January 2017

WE'RE STICKING WITH our positive stance on alcoholic drinks giant **Diageo (DGE)**, our 'buy' call modestly in the money following better-than-expected first half results (26 Jan). These revealed organic volume growth of 4.4%, ahead of expectations of 3.1% and helped by *Johnnie Walker* whisky and the reinvigorated US business.

While Diageo's shares have enjoyed a rally over the past two months, management's tone is upbeat and we think there are more positives to emanate from the turnaround. In particular, productivity and cost savings are coming through.

Diageo remains a high-quality name worth owning given 2017's uncertainties. Strong brands represent an economic moat, engendering loyalty among consumers, conferring pricing power upon Diageo and creating barriers to entry for rivals. Earnings are geographically diversified and free cash flow generation remains strong – up £245m to £1.08bn in the six months to December – supporting investment in competitive



advantage and a progressive dividend. The payout was up 5% to 23.7p at the interim stage.

SHARES SAYS: ↗

We're in agreement with the bullish consensus view, heartened by the improved first half results from the world's biggest spirits business. (JC)

BROKER SAYS: 17 11 2

DAILY MAIL & GENERAL TRUST

(DMGT) 697p

Loss to date: 7.1%

Original entry point:

750p, 6 October 2016

A DISAPPOINTING UPDATE (26 Jan) from newspaper publisher and business-to-business (B2B) information group **Daily Mail & General Trust (DMGT)** has wiped out earlier gains from our trade on the stock. However, it doesn't change our positive view of the investment case.

Growth at the company ground to a halt in the last three months of 2016. Revenue was flat at £520m year-on-year but the company says it is still on track to hit expectations for the full year to 30 September 2017.

Guidance for underlying revenue growth in the DMG information business was reduced from high-single digit to mid-single digit.

Chief executive Paul Zwillenberg, who was appointed in May 2016, took advantage of the share price slump to buy nearly £35,000 worth of stock at 693.76p.

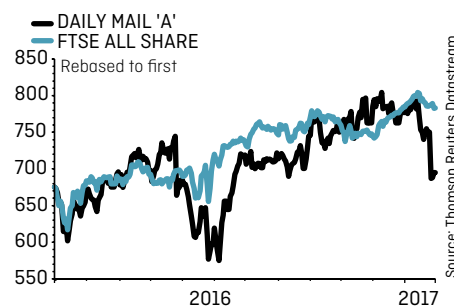
Liberum analyst Ian Whittaker said DMGT benefits from having a portfolio of businesses where some parts can offset weakness elsewhere in the business.

Whittaker who has a 'buy' recommendation and 900p price target says a reorganisation of this portfolio can unlock value not currently recognised by the market.

SHARES SAYS: ↗

We still think Zwillenberg can create value for shareholders despite a somewhat disappointing start to the financial year. (TS)

BROKER SAYS: 6 7 3



the share price slump to buy nearly £35,000 worth of stock at 693.76p.

Liberum analyst Ian Whittaker said DMGT benefits from having a

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SLICK PICKS

FOUR OIL FIRMS WITH HOT PROSPECTS

Oil exploration can create substantial value overnight. Successful exploration can drive share prices higher as the market prices in the upside from a big oil or natural gas discovery.

In the past companies such as **Tullow Oil (TLW)** and **Cairn Energy (CNE)** rode exploration success all the way to the FTSE 100 index.

There are signs activity is now picking up following several quiet years for high impact drilling. Explorers are taking advantage of reduced drilling costs and increased availability of rigs.

In this article we highlight four examples where exploration results could impact the destinies of the individual companies and the continued recovery of the wider sector.

SLICK RECOVERY

In January 2016, the oil price was bobbing around multi-decade lows below \$30 per barrel as investors fretted about the Chinese economy. Twelve months later it is holding steady above \$50 per barrel with producers' cartel OPEC poised to take further action to support the market.

The oil exploration and production (E&P) sector has started to price in this reversal in fortunes.

For this run to be sustained over the coming months certain criteria must be met. We think the most important is drilling success.

Big discoveries have been in short supply for some time. The E&P sector was underperforming even before the oil price began to crater in June 2014. We believe that could change in 2017.

THE E&P SECTOR WHAT TO WATCH IN 2017

OIL PRICES

Predicting the future direction of oil prices is always a difficult job and in 2017 more than ever.

Investors need to balance several factors in their heads including the policies of US president Donald Trump who wants to boost domestic production.

The consensus expects a gradual build in oil prices as the market starts to rebalance.

The World Bank's forecast for an average oil price of \$55 per barrel in 2017 is not untypical of other people's views.

Notably there have been noises that Saudi Arabia would be prepared to back further production cuts following last autumn's landmark agreement to curb output from key producing regions.

Geopolitical factors and supply outages are the great unknown which could deliver short-term spikes in crude.

We think investors should focus on companies which can prosper in a stable price environment. Anyone really bullish on crude may wish to look at heavily indebted companies like **EnQuest (ENQ)** and **Premier Oil (PMO)** as they are highly leveraged to oil prices so could increase by a far greater amount than the commodity value itself.



EXPLORATION SUCCESS

A Barclays survey of 215 global oil and gas companies implies a greater willingness to invest as OPEC has moved to provide a floor for prices. Spending is expected to rise 7% this year.

In January, Norwegian firm **Statoil (STL:OSE)** announced plans to increase exploration for the first time in four years with 30 exploration wells lined up for 2017.

This strategy makes sense. A big reduction in costs now makes drilling wells significantly less expensive. A potential recovery in crude down the line could make discoveries particularly lucrative once they are brought on stream.

CAPITAL DISCIPLINE

The ability of companies to keep a tight rein on costs is crucial for sentiment towards the sector given a patchy track record in this area.

The market is likely to be alive to any signs of renewed cost inflation.

Projects need to be delivered on time and on budget and the few companies which have tapped the equity markets need to demonstrate those funds are being put to good use.

The cash raised by the likes of **Hurricane Energy (HUR:AIM)**, which raised more than £120m on separate occasions in 2016, and **Amerisur Resources (AMER:AIM)** demonstrates there is a market appetite for the right story.

M&A ACTIVITY

Normally by this point in the cycle you would have expected more widespread consolidation. Those with plenty of cash at their disposal should have picked up barrels on the cheap, in our opinion.

This hasn't happened apart from the £35bn tie-up between **Royal Dutch Shell (RDSB)** and BG. Instead, the market has been flooded with assets being divested by the big oil companies.

But are we at a turning point? The big five oil majors announced upstream acquisitions totalling \$5.7bn in December 2016, according to consultant Ernst & Young. This is more than the combined value of all upstream acquisitions made by these companies in the other 11 months of that year.

CAIRN ENERGY (CNE) 240P

COMPANY BACKGROUND: Cairn Energy's (CNE) fortunes soared in 2004 when a field in Rajasthan, northern India, was found to contain almost 1.1 billion barrels of oil. It bought the assets from **Royal Dutch Shell (RDSB)** for just \$7.5 million three years earlier.

This discovery ultimately catapulted Cairn into the FTSE 100 index.

More recently, the company suffered a few patchy years which included expensive and unsuccessful drilling offshore Greenland and a tax dispute with the Indian authorities.

Cairn rediscovered its exploration mojo offshore Senegal in 2014. The SNE discovery is seen as having multi-billion barrel potential.

WHAT IS IT DRILLING AND WHEN? Cairn has announced its intention to drill two wells on its 40%-owned SNE project from late January. It has options for follow up drilling should the first round prove successful.

WHAT IS THE FUNDING SITUATION? Investors can have confidence in Cairn's ability to fund even an extended drilling programme without returning to the market.



**CHASING
MULTI-BILLION
BARREL
POTENTIAL**



It has one of the strongest balance sheets in the sector with net cash of \$335m. However, Cairn is increasing its debt funding with a credit facility expected to hit \$350m at its peak.

Capital expenditure is guided at \$295m in 2017, of which \$125m is committed to appraisal drilling and the remainder to its development projects in the UK.

HOW HIGH ARE THE RISKS? In E&P terms the risks are relatively modest. Cairn knows there is oil; the main question is how much of this oil it can commercially produce.

The company is not wholly reliant on this activity. It has a diversified portfolio which includes development assets in the North Sea.

WHAT IS THE POTENTIAL REWARD? The results from these wells should offer an indication of how much can be recovered from the estimated 2.7bn barrels in place at SNE. Current estimates stand at gross recoverable resources in the region of 500 million barrels. This number could swiftly ramp up if the upcoming drilling campaign is successful.

HURRICANE ENERGY (HUR:AIM) 46.6P

COMPANY BACKGROUND: Hurricane was established to exploit so-called 'fractured basement reservoirs'.

Co-founder Robert Trice says these overlooked assets could provide a fresh wave of commercial discoveries in what is a mature oil and gas province.

A fractured basement reservoir is a body of rock beneath the earth formed more than 2bn years ago. In certain places these massive structures – located deeper than the sandstones which have traditionally been the focus of oil exploration in the UK – have been pushed up and violently fractured by earthquakes and other tectonic forces.

The hydrocarbons discovered by Hurricane are contained within the cracks in these formations.

Yemen, Libya and Vietnam have successfully exploited fractured basement reservoir potential and Hurricane looks to be on the road to emulating this success.

Hurricane is concentrating its efforts in the area

WEST OF
SHETLAND



TARGETING NEW RESERVOIRS IN UK WATERS



of the North Sea West of Shetland. Its first big success came with the Lancaster well in June 2014 and, ultimately, it is estimated the company has uncovered as much as 500 million barrels of oil.

This activity has been backed by shareholders with the company raising more than £120m during 2016.

WHAT IS IT DRILLING AND WHEN? This latest well on the Halifax prospect is already in progress with results expected around the end of the first quarter of 2017.

WHAT IS THE FUNDING SITUATION? The company is funded for this well by the money raised on the stock market last year. However before it submits a field development plan for the Lancaster field it needs to raise as much as \$400m (£320m).

HOW HIGH ARE THE RISKS? This is not a wildcat exploration well. It is being drilled in relatively close proximity to an existing discovery although the exploitation of fractured basement reservoirs in UK waters is still in its infancy.

WHAT IS THE POTENTIAL REWARD? If it can demonstrate that Halifax is an extension of the existing Lancaster discovery then resource estimates of around 500 million barrels of oil could be doubled.

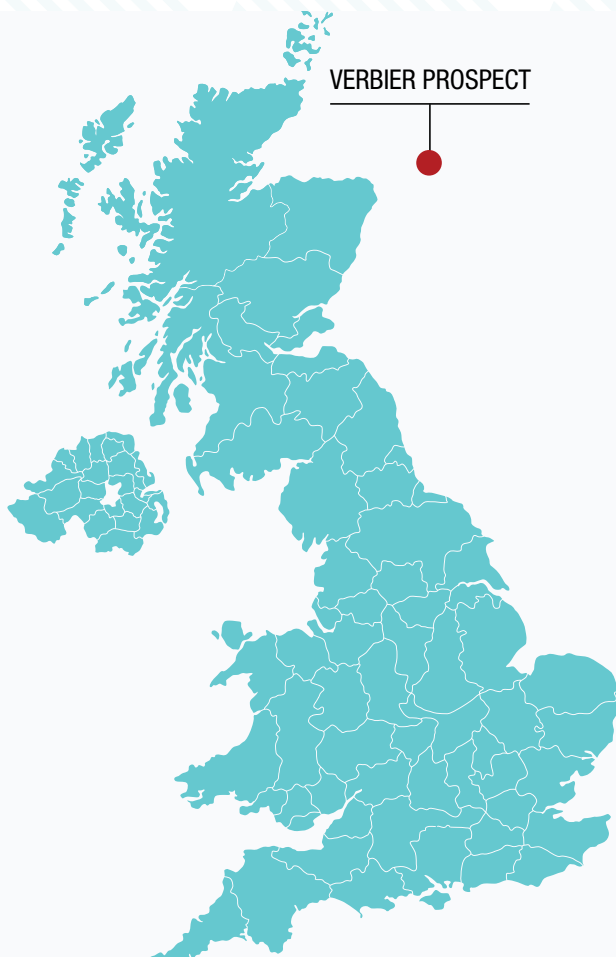
JERSEY OIL & GAS (JOG:AIM) 134P

COMPANY BACKGROUND: Previously known as Trap Oil, the company was renamed and relaunched in 2015 following severe financial difficulties. Chief executive Andrew Benitz joined the business along with chief operating officer Ron Landsell; both previously worked for Aussie explorer Longreach Oil & Gas.

Their main achievement has been to secure Norwegian firm Statoil as a partner on Jersey's PL2170 licence in the North Sea. This helped drive a big increase in the share price in the second half of 2016.

WHAT IS IT DRILLING AND WHEN? The plan is to drill the Verbier prospect on PL2170 this summer.

WHAT IS THE FUNDING SITUATION? Under the terms of the agreed farm-out deal, Jersey enjoys a full carry from Statoil on its 18% interest in Verbier up to a gross well cost of \$25m.



**HIGH
RISK GIVEN
SINGLE WELL
FOCUS**



An oversubscribed placing in November 2016 raised £1.6m and the company currently has no debt.

HOW HIGH ARE THE RISKS? In a recent research note, stockbroker WH Ireland commented: 'We believe a well drilled by Talisman in 2006, the 20/5a-10Y well, materially de-risks Verbier as a viable prospect.

'That well was production tested at 4,800 barrels per day plus 2.6 million cubic feet of gas per day from sands of similar age to those being targeted at Verbier.'

The broker puts the chance of success at 18.7%. A rig is not yet secured for the well but Statoil has provided the UK Oil & Gas Authority with a firm commitment to drill.

Jersey's fortunes are heavily tied to this well and an unsuccessful result would damage its share price.

WHAT IS THE POTENTIAL REWARD? Based on Jersey's pre-drill estimates a successful exploration well at Verbier would uncover 113 million barrels of recoverable oil (gross), which according to WH Ireland's calculations could have a value net to Jersey of 986p per share.

PROVIDENCE RESOURCES (PVR:AIM)

COMPANY BACKGROUND: Founded and headed by Tony O'Reilly Jr, the son of Irish entrepreneur Sir Anthony O'Reilly, the company is notable for the Barryroe discovery in Ireland's Celtic Sea. It is still seeking a farm-out partner nearly five years on.

Providence also drilled a well in partnership with **ExxonMobil (XOM:NYSE)** on the substantial Dunquin prospect in the Porcupine basin.

This geological feature is located in the Atlantic Margin to the west of Ireland. Pre-drill Dunquin had been estimated to contain as much as 8.4 trillion cubic feet of gas and 316 million barrels of associated liquids. Initial results were disappointing and follow-up drilling also failed to deliver.

The company was forced into a \$48m placing at 12p in June 2016. The 17p share price is a long way below Providence's all-time peak in 2012 of more than 700p.

WHAT IS IT DRILLING AND WHEN? Providence has booked in the drill ship Stena IceMAX for a one-well slot in 2017 with the option of a second well.

The first well will be designed to target two separate prospects – Druid and Drombeg – and is likely to be drilled this summer.

Like Dunquin, they are located in the Porcupine basin and the company has an 80% interest in both prospects.

A third well on the Newgrange prospect, in the

PROVIDENCE
HAS A LOT
TO PROVE

same basin, is a possibility but would probably require the company to secure a farm-out partner.

WHAT IS THE FUNDING SITUATION?

It looks pretty tight but Davy estimates the company has \$35m at its disposal to cover drilling costs and this is the rough estimate of cost of drilling a well on Druid and Drombeg.

The relatively modest budget shows the benefit of drilling at the point in the cycle when costs are substantially reduced.

A previous well on Druid in 2013 reportedly cost more than \$200m.

HOW HIGH ARE THE RISKS? Significant. The balance sheet situation means cost over-runs could be damaging and the company is yet to secure regulatory approval for the well. Davy has a 10% chance of success for Drombeg and Druid.

WHAT IS THE POTENTIAL REWARD? Again, significant. Druid is estimated to contain up to 3.1 billion barrels of oil and Drombeg 1.9 billion.



Are motor retailers out of gas?

Market may be too pessimistic on outlook for motor traders

Q uoted motor retailers' shares have fallen heavily along with other domestically-exposed names following the vote for Brexit. Investors are pricing in a softer outlook for the industry, which already appeared to be cooling having enjoyed a sustained boom in new car sales. The Society of Motor Manufacturers and Traders (SMMT) is forecasting new car registrations to fall by 5% in 2017.

But there are opportunities for contrarian investors. *Shares* would steer any investors towards sector constituents with proven management, strong balance sheets and the ability to grow earnings through the cycle, both organically and through acquisitions.

GAS IN THE TANK

Poor sentiment towards car retailers reflects expectations of a slower new car market in 2017 and 2018 and their exposure to big ticket-item purchases, as well as headwinds including sterling weakness and its unknown impact on manufacturers' strategies as well as rising costs (national living wage, business rates, apprentice levy).

Most operators have highlighted a robust used car market, although newly listed used car specialist **Motorpoint (MOTR)** crashed following a profit warning (19 Oct '16)



blamed on referendum-related uncertainty and margin pressure caused by falling residual used car values.

Zeus Capital's automotive retail expert Mike Allen says 'interest rates are likely to remain low for the foreseeable future, and we continue to believe the PCP (Personal Contract Purchase) cycle will result in greater activity levels potentially providing a shallower trough point vs. previous economic cycles.

'A weaker new car market should also benefit future residual values further down the line, as it alleviates the margin pressure on 0 – 3 year-old cars, which has a greater impact on

the operational gearing of motor retailers. Aftersales will continue to benefit from high levels of new car activity since 2011.'

Allen also believes comparisons to the 2008 downturn are overdone, since most companies have better balance sheets and systems and are also benefiting from shorter buying cycles and better earnings visibility thanks to PCP.

Canaccord Genuity analysts Sanjay Vidyarthi and David Jeary highlight the potential for continued positive newsflow, at least into August's interim reporting season.

Referencing the new car registrations forecasts, they

note: ‘We maintain our view that the issue here is not about the headline level of decline, rather it is about whether the decline is a function of supply (less OEM push) or demand.

‘It is imbalance between the two which will cause greatest pain to the dealers through gross margin pressure. We think that there could be less push, given sterling weakness and the strength of demand in Europe, making a decline in the market more manageable for dealers.’

The analysts highlight the prospect of a strong March as demand is pulled forward ahead of changes to Vehicle Excise Duty (road tax) due to be implemented on 1 April, which will lead to a more onerous charging structure.

This, argues the broker, could provide a re-rating catalyst for underrated players including **Lookers (LOOK)**, boasting one of the broadest spreads of brands in the industry, successful buy and build **Vertu Motors (VTU:AIM)** and the ambitious **Cambria Automobiles (CAMB:AIM)**, where savvy CEO Mark Lavery has plenty of ‘skin

WHAT IS PCP?

PCP or Personal Contract Finance is a financing option for a prospective car purchaser which offers a vehicle for a variable deposit at a monthly fee. At the end of the (usually) three-year period, customers either hand the car back, make a ‘balloon payment’ and own the car outright, or put any equity they have in the car towards a new model.

in the game’ with a 40% stake.

MAKING SENSE OF M&A

Canaccord’s Vidyarthi and Jeary also explain that ‘a common refrain among investors that we have met recently has been that the motor retailers are over-paying for acquisitions at the top of the cycle.’ However the pair has used annual reports filed at Companies House to dig into the financials of some recently acquired businesses.

Deconstructing recent Lookers and Vertu M&A, Canaccord argues that the headline

multiples are mis-leading in the context of the freehold property that has been acquired as well as the potential profit upside.

For instance, with Lookers’ £55.4m acquisition of Drayton, by deducting the freehold property value from the deal cost as well as a notional rent, then adding back directors’ costs (since Lookers’ management has taken over the business), the pre-tax multiple drops significantly.

With Vertu Motors, steered by canny industry operator Robert Forrester, the broker illustrates how the multiples paid for 2016 acquisitions Sigma and Gordon Lamb are far lower, once freeholds are deducted and directors’ costs added back.

SHARES SAYS: ↗

We’re positive on oversold-yet-growing operators with strong balance sheets including Vertu and Cambria, while global distributor Inchcape’s (INCH) overseas exposure in a weak sterling environment should provide insulation for tougher times ahead. (JC)

LOOKERS RECENT ACQUISITION METRICS

£m	Benfield	Knights	Drayton
Consideration	87.5	27.2	55.0
Less freehold	(48.0)	(19.0)	(21.0)
Adj consideration	39.5	8.2	34.0
Historic reported PBT	7.0	1.9	5.2
Sale & leaseback adj at 5% yield	(2.4)	(1.0)	(1.1)
Add back directors’ costs	1.2	0.2	0.8
Adj PBT	5.8	1.2	5.0
Headline PBT multiple (x)	12.5	14.3	10.6
Adj PBT multiple (x)	6.8	6.8	6.8
Adj post tax multiple (20% tax) - (x)	8.4	8.6	8.5

Source: Canaccord Genuity Estimates, company reports

VERTU RECENT ACQUISITION METRICS

£m	Sigma	Gordon Lamb
Consideration	30.9	18.7
Less debt paid off	(9.0)	-
Less freehold	(17.8)	(7.5)
Adj consideration	4.2	11.2
Historic reported PBT	1.2	2.7
Add back interest cost	0.6	-
Sale & leaseback adj at 5% yield	(0.9)	(0.4)
Add back directors’ costs	0.7	0.3
Adj PBT	1.6	2.6
Headline PBT multiple (x)	*18.3	6.9
Adj PBT multiple (x)	2.7	4.2
Adj post tax multiple (20% tax) - (x)	3.3	5.3

Source: Canaccord Genuity Estimates, company reports
*assumes no adjustment for interest cost saving

FRIDAY 3 FEBRUARY

ECONOMICS

UK

SERVICES PMI

EU

FINAL SERVICES PMI

US

UNEMPLOYMENT RATE

NON-FARM EMPLOYMENT CHANGE

MONDAY 6 FEBRUARY

FINALS

RANDGOLD RESOURCES

RRS



BP (BP.)

Oil major BP (BP.) will announce its full year numbers on 7 February. Although the company has largely resolved liabilities associated with the Gulf of Mexico oil spill in April 2010, ongoing cash outflows are still an issue. The market may therefore look for guidance on this matter as well as management's continuing ability to strip out costs.

TUESDAY 7 FEBRUARY

FINALS

BP BP.

ST MODWEN PROPERTIES SMP

TRADING STATEMENTS

BELLWAY BWY

UDG HEALTHCARE UDG

AGMS

GOWIN NEW ENERGY GWIN

WEDNESDAY 8 FEBRUARY

FINALS

RIO TINTO RIO

SMURFIT KAPPA SKG



ST MODWEN PROPERTIES (SMP)

Full year results on 7 February from real estate developer St Modwen Properties (SMP) provide an opportunity for incoming chief executive Mark Allan and finance director Rob Hudson to outline their plans for the business. Investment bank Liberum believes the company has self-help potential and could soon sell its Nine Elms residential property scheme. 'St Modwen's significant 6,000 acre land bank provides a long-term pipeline of value creation potential,' adds Liberum. 'Risks are partly mitigated by an income generating portfolio, which covers the majority of overhead and interest cost.'

TULLOW OIL TLW

INTERIMS

DUNELM DNLM

GLAXOSMITHKLINE GSK

HARGREAVES LANSDOWN HL.

SOPHOS SOPH

UK COMMERCIAL PROPERTY TRUST UKCM

TRADING STATEMENTS

SEVERN TRENT SCT

AGMS

GRAINGER GRI

THURSDAY 9 FEBRUARY

FINALS

HENDERSON GROUP HGG

SMITH & NEPHEW SN.

INTERIMS

ASHMORE ASHM

FRONTIER DEVELOPMENTS FDEV

INNOVADERMA IDP

TRADING STATEMENTS



RIO TINTO (RIO)

The market will focus on future capital expenditure plans, cost efficiency and comment on the state of the commodities industry when Rio Tinto reports full year results on 8 February. The FTSE 100 miner has already told the market about its full year production, so the focus will be on financials in the results. A particular area of interest will be guidance on the dividend. Miners have been generous dividend payers during the commodities downturn over the past four years, effectively paying investors to wait for a recovery in prices. Dividend growth may now become second place to investing in growth projects for the future as commodities begin their upwards cycle once more.

DAIRY CREST DCG

ENTERPRISE INNS ETI

GRAINGER GRI

PENNON GROUP PNN

TATE & LYLE TATE

THOMAS COOK TCG

EX-DIVIDEND

ALBION ENTERPRISE

VCT AAEV 2.5P

DAEJAN DJAN 35P

GATELEY GTLY 2.2P

STAGECOACH SGC 3.8P

SAGE SGE 9.35P

AGMS

EASYJET EZJ

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ETFs: WHY, HOW AND WHEN TO INVEST



ARE SHARE SPLITS A WASTE OF TIME?



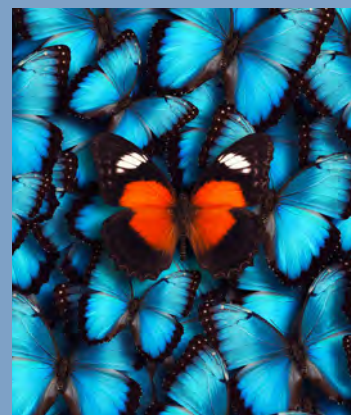
LITTLE KNOWN CONSULTANT STARTING TO LOOK INTERESTING



INCOME OPPORTUNITIES AMONG RETAIL BONDS



IS THERE ANYTHING UNIQUE ABOUT SPECIAL SITUATION FUNDS?



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BROKER RATINGS EXPLAINED:

We use traffic light symbols in the magazine to illustrate broker views on stocks.

Green means buy, Orange means hold, Red means sell.

The numbers refer to how many different brokers have that rating.

Eg: **4** **2** **1** means four brokers have buy ratings, two brokers have hold ratings and one broker has a sell rating.

The traffic light system gives an illustration of market views but isn't always a fully comprehensive list of ratings as some banks/stockbrokers don't publicly release this information.

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ETFs DEMYSTIFIED: PART 1 OF OUR FUND SERIES

WHY ETFs CAN BE ATTRACTIVE AND THE TOP FIVE QUESTIONS TO ASK BEFORE INVESTING IN THEM



You may have heard of exchange-traded funds (ETFs), but have you actually invested in any? Over the next three weeks we will explain their appeal and how they can play an important role in your investment strategy.

In the coming weeks we will also discuss how many ETF products are very clever in how they focus on specific factors like value, momentum and quality.

Many people only talk about ETFs being low cost instruments and don't really consider any other points. In reality, there is much more to consider with ETFs such as the stocks or other asset classes they are tracking and why you would want to have such exposure in your portfolio.

We will touch on all those points in our three-part series so that you can better understand why ETFs can potentially enhance your returns and be more efficient investment vehicles than some mainstream actively-managed funds.

WHAT ARE ETFs?

Exchange-traded funds are growing in popularity as a simple, low-cost tool for getting access to a range of companies, commodities and countries across the globe.

They are similar to funds in that they invest in a pool of assets and provide exposure to a particular theme or market.

The key difference is ETFs are traded on an exchange. This means you can buy and sell them at any time during trading hours, at the price shown.

ETFs are fairly transparent. Unlike a fund, whose manager might be reluctant to reveal their holdings and tactics, you can generally see what ETFs are investing in. This is because the vast majority of ETFs track a specific index. They will clearly state the name of each index, so you can easily check how that index is constructed.

ETFs fall under a broader umbrella of exchange-traded products (ETPs), which also include exchange-traded certificates (ETCs) and exchange-traded notes (ETNs).

ETCs track specific baskets of commodities, such as gold, wheat or corn. ETNs are more complicated because they're issued as senior debt notes, which introduces credit risk.

In our opinion, retail investors shouldn't get involved with ETNs unless they are very experienced and fully understand the risks.

ARE ETFs AIMED AT CERTAIN TYPES OF INVESTORS?

ETFs are relevant for both short-term and long-term investors. Traders sometimes use them to play the market. Biotech ETFs, for example, saw significant inflows around the US election as a short-term trade on Donald Trump winning the presidency.

The pharmaceutical and biotechnology sector had previously been dragged down by concerns that Hillary Clinton would impose strict price caps on drugs (and therefore hurt corporate profitability in the drug sector) if she had won the US presidential election.

ETFs are also good vehicles for long-term investing and can form the core part of an investment process.

WHAT ARE THE FEES COMPARED TO AN ACTIVELY-MANAGED FUND?

In recent years, ETFs have become very popular among retail investors. Part of their appeal is their low-cost. In general, ongoing charges for ETFs are in the range of 0.30% compared with 0.75% to 1.25% for a traditional actively-managed fund.

Chris Mellor, executive director at ETF provider Source, says fees are extremely important in the current environment of low interest rates, which have led to poor returns on fixed income and lower growth rates for equities. 'High fees eat into returns a lot more in this environment, so there is a lot of pressure to reduce fees,' he says.

In recent years there has been a lot of furore around the inability of several active fund managers to beat their benchmarks. In the US, for example, more than 99% of active funds have trailed their benchmark over the past 10 years, according to S&P Global.

'Every pound you pay to someone to manage your money for you is money which cannot work for you in the market,' says Adam French, co-founder and chief executive of online wealth manager Scalable Capital.

As we mentioned at the start of this article, cost is not the be-all and end-all. There are a whole range of factors to consider before buying an ETF.

TYPICAL FEES FOR ETFs CAN BE CIRCA 0.30% A YEAR VS 0.75% TO 1.25% FOR TRADITIONAL ACTIVELY-MANAGED FUNDS

GOVERNMENT BOND ETF ETF ETF ETF ETF ETF ETF ETF
ETF INVESTMENT GRADE ETF ETF ETF ETF ETF ETF ETF
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ETF ETF ETF ETF ETF ETF ETF ETF ETF ETF EXPOSURE

TOP FIVE QUESTIONS TO ASK BEFORE INVESTING IN AN ETF

1 WHAT IS THE UNDERLYING INDEX?

Exchange-traded funds track a huge array of indices. Some track well-known indices like the FTSE 100 or S&P 500 which feature large companies on the UK and US stock markets, respectively. Other indices track emerging or frontier markets. Some track specific sectors like technology; and others track fixed income securities.

You should look at the underlying index being tracked and consider why you want exposure to it. If you're a new investor you might want to opt for a very broad ETF. For example, a suitable product might be **Source MSCI World UCITS ETF (MXWO)** whose constituent equities give you access to several developed markets.

Mellor says you could then add other ETFs to skew your portfolio, take a particular view or broaden your exposure.

If you think the US is going to do well you could invest in **Source S&P 500 UCITS ETF (SPXP)**, which gives you exposure to the largest companies in the US, such as **Apple (AAPL:NDQ)**, **Microsoft (MSFT:NDQ)**, **Amazon (AMZN:NDQ)**, **Facebook (FB:NDQ)** and **JPMorgan Chase (JPM:NYSE)**.

If you want to add some emerging markets

exposure to your portfolio you could invest in a broad emerging markets ETF, such as **Vanguard FTSE Emerging Markets UCITS ETF (VFEM)**. Its top holdings include **Tencent (0700:HKG)**, **China Construction Bank (0939: HKG)** and **China Mobile (0941:HKG)**.

Broad ETFs are useful if you want to spread risk and don't know enough about a single country's economic prospects.

Just because an index is located in a particular country, it doesn't necessarily mean you'll get exposure to that country's economy.

The UK's FTSE 100, for example, contains several global companies and less than a third of total profits come from the UK.

The FTSE 250 index, which includes the 250 next-largest companies on the UK stock market, is more domestically-focused and includes companies like **Auto Trader (AUTO)**, **Rightmove (RMV)** and **Travis Perkins (TPK)**. An example of an ETF tracking this index is **iShares FTSE 250 UCITS ETF (MIDD)**.

ETFs ARE A GREAT AND EASY WAY TO DIVERSIFY YOUR PORTFOLIO

2 DO I ALREADY HAVE EXPOSURE?

It's important to take a close look at the assets within an index and check whether you already have exposure via other investments in your portfolio.

If you invest in a biotech fund, you might want to steer clear of a specific biotech ETF as they could ultimately track the same companies.

Similarly, an S&P 500 ETF might not be suitable for someone who already has individual shares in Apple, Amazon and Facebook as these are among the big companies in the US index.

Morningstar puts ETFs and active funds into specific categories which can help you avoid duplication. For example, **Source EURO STOXX 50 UCITS ETF (SX5S)** is in the Eurozone large-cap equity category because it offers exposure to the 50 largest stocks in the Eurozone, including **Siemens (SIE:ETR)**, **Bayer (BAYN:ETR)** and **Allianz (ALV:ETR)**.

3 WHAT ARE THE FEES?

Although ETFs are low-cost, the fees can vary widely. The average fee across Europe is 0.29%. A core FTSE 100 ETF is much cheaper than a niche single emerging market ETF because



the FTSE 100 is less volatile and easier to track. The **iShares FTSE 100 UCITS ETF (CUKX)** has an ongoing charge of just 0.07%.

You can also get access to fees this low by opting for a similar non-ETF product – namely a tracker fund. **BlackRock 100 UK Equity (GB00B7W4GQ69)**, which also tracks the FTSE 100, has an ongoing charge of 0.06%.

Unlike ETFs, trackers aren't listed on a stock exchange and their units are typically priced at midday.

It is possible ETF fees could reduce even further in the future as products become more popular and competition among providers intensifies.

In the US, fees are trending towards zero, with some products having ongoing charges as low as 0.03%. Mellor says some providers engage in stock lending as a way to make money, or bundle their ETFs with other products.

MAKE SURE YOU FULLY UNDERSTAND HOW AN ETF WORKS AND HOW IT TRACKS AN INDEX BEFORE INVESTING

4 IS THERE A HISTORY OF TRACKING ERROR?

It's important to look at whether the ETF is succeeding in its aim of accurately tracking a specific index or whether it has underperformed. Any difference between the return of the index and the ETF is called tracking error.

ETF providers will usually highlight a product's tracking error in their factsheet through a percentage-based 'standard deviation' figure.

The higher a fund's tracking error, the more likely it is to outperform or underperform its benchmark in any single period.

Reasons for tracking error include the rebalancing costs incurred when an index's methodology requires a reweighting of its constituents. You sometimes get 'cash drag' when funds have to hold a portion of their portfolio in cash, for example to make dividend distributions. There can also be execution errors, issues with securities lending and when the ETF using a 'sampling' replication method.

According to Morningstar, ETFs which track emerging market equities tend to exhibit higher tracking error than those based on developed market large cap indices.

5 DOES THE ETF ACTUALLY INVEST IN THE ASSETS THAT FEATURE IN THE INDEX?

ETFs track an index in one of two ways: physical replication or synthetic replication.

Physically replicating products hold either all or a sample of the underlying assets that make up the index.

Sampling is common when the index being tracked has a very large number of stocks or when some of the stocks are not very liquid.

Sampling helps keep costs down because there are fewer companies to buy or sell each time the index is rebalanced. However, tracking error is more likely because some of the index constituents are excluded from the product.

ETFs which use synthetic replication don't hold the underlying assets. Instead, they replicate the performance of the index via swap agreements. A counterparty contracts to deliver the return of the underlying assets, minus a fee.

Tracking error tends to be less common in synthetic ETFs but there is a risk of the counterparty defaulting on their obligations, potentially exposing you to losses. Synthetic ETFs are backed by collateral to minimise the impact of a default.

Mellor says it doesn't really matter which method of replication is being used, particularly when it comes to long-term investors. 'Both deliver similar outcomes and have positives and negatives associated with them,' he says.

Darius McDermott, managing director at financial adviser Chelsea Financial Services, claims synthetic ETFs are less transparent than physical ETFs because they don't hold the underlying securities of the index.

'Synthetic ETFs can be an easy way of accessing assets that are hard to actually own – like commodities. You just need to know the added risks involved,' he says.

TOP SELLING ETFs AMONG AJ BELL YOUINVEST CUSTOMERS

1	iShares Core MSCI World
2	Vanguard S&P 500
3	SPDR FTSE UK All Share
4	Vanguard FTSE 250
5	iShares Core S&P 500
6	iShares Core FTSE 100
7	Vanguard FTSE 100
8	UBS ETF MSCI Emerging Markets
9	Vanguard FTSE Japan
10	iShares FTSE 250

(30 days to 18 January 2017)

SOURCE MSCI WORLD UCITS ETF (MXWO)

SOURCE MSCI WORLD UCITS ETF is a global product which aims to track the performance of the MSCI World Total Return (Net) Index. The index comprises 1,600 large and mid-cap stocks across 23 developed countries.

The US is by far the largest geographic exposure, taking up a 58.5% share. As a result, the largest holdings in the index are very similar to the S&P 500. It includes well-known names like Apple, Microsoft and Facebook.

In addition, the ETF gives exposure to Japan (8.6%), the UK (6.7%) and Canada, France, Germany and Switzerland (all at under 4%), along with a few other countries.

The index is well-diversified on a sector basis, providing exposure to the financials, IT, consumer discretionary, healthcare, industrials, consumer staples, telecoms, materials and energy sectors.

MSCI describes the index as a 'building block' around which investors can build a portfolio. For example, you could consider adding small cap exposure, emerging markets, specific sectors or ETFs which focus on particular stock characteristics.

Source's Chris Mellor says the product could be suitable for someone who is new to investing. 'The index is broad and consists of solid large cap holdings. If an investor doesn't have a particular view on any region or sector, MSCI World offers a good base holding,' he says.

Scalable Capital's Adam French suggests the ETF could form part of a diversified portfolio for someone who is looking for broad equity exposure. However, he says the amount of equities an investor should typically hold in their portfolio varies greatly depending on their personal circumstances.

A key difference between Source's product and other MSCI World ETFs is Source uses a 'swap-enhanced' structure.

It contracts with one or more banks who agree to pay any difference between the portfolio performance and the index performance, less any

applicable fees. These contracts are known as swaps.

It invests in physical equities but there is a swap overlay to try to minimise tracking error. The fund uses multiple counterparties to reduce the potential impact of a default.

The ETF has a total return of 35.8% over the past year (to 23 January) and a five-year annualised total return of 14.4%, according to Morningstar. Total return is the combination of both share price performance and any income paid by the product.

THIS MIGHT SUIT SOMEONE NEW TO INVESTING



SOURCE MSCI WORLD UCITS ETF

Total expense ratio: 0.19%

Replication method: Physical with swap overlay

Dividends: Accumulating

1 year total return: 35.8% (as of 23 January 2017)

SOURCE MSCI WORLD UCITS ETF: TOP 10 INDEX HOLDINGS

1	Apple
2	Microsoft
3	Exxon Mobil
4	Johnson & Johnson
5	JPMorgan Chase
6	Amazon
7	General Electric
8	Facebook
9	Wells Fargo
10	AT&T

SOURCE MSCI WORLD UCITS ETF: GEOGRAPHIC EXPOSURE

US	58.5%
Japan	8.6%
UK	6.7%
Canada	3.7%
France	3.5%
Germany	3.4%
Switzerland	3.3%
Other	12.3%

NEXT WEEK: GETTING CLEVER WITH ETFS: QUALITY, SIZE AND VALUE

Brazil's economy strangled by high cost of lending

Central bank is cutting rates, but will it be enough to revive the country?

The term 'BRIC' was coined in 2001 and referred to some emerging world economies. The 'B' was for Brazil – Russia, India and China made up the rest – and it's an economy that seems to entice and worry investors in almost equal measure.

Brazil is no backwater in world rankings. It is ninth in the world by GDP measure, and in 2012 edged ahead of the UK's economy for a brief period.

VOLATILE ECONOMY

As is often the case, sharp growth was followed by an equally sharp turnaround.

Last year saw GDP shrink by 3.5%, leading many economists to slash their growth forecasts for 2017 to only 0.5%.

Brazil has had its worst two-year recession in more than 100 years. Adding to this bleak backdrop is the cost of lending.

Interest rates are some of the highest in the world. The effective overnight rate for banks is already in double digit percentages; smaller businesses have to pay rates of 20% or more.

With this sort of cost for borrowing, it is difficult to have great expectations for growth in the short to medium term at least.

The political backdrop has been less than helpful too. Last year saw President Dilma

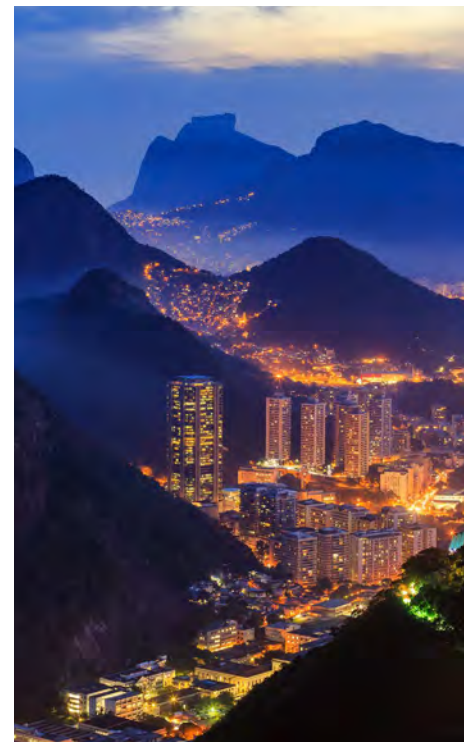
Rousseff removed from office and impeached.

The new regime has attempted to rein in some of the excesses of public spending seen previously, so this could be one reason to start seeing the future of the economy with slightly less pessimism.

The forex market tends to be the quickest to react to economic change. Two years ago one US dollar would buy two and a half reals. The Brazilian currency had weakened considerably by the end of 2015 and the dollar was worth more than four reals.

REALS RECOVERY

Since then the Brazilian currency has clawed back some ground. That presents problems in terms of making the country's exports



more expensive than they were a year ago.

Considering all of this, it is difficult to come up with an immediately positive argument for Brazil's economy this year.

Interested investors may want to keep an eye on quarterly growth figures, to see if this dire recession is coming to an end. A move lower on interest rates would also start to bolster the bullish case.

The foreign exchange market does seem to think that the outlook is better than a couple of years ago. Sadly economies seldom perform immediate u-turns, so any move back to previous glory days is going to take some time for Brazil. (DJ)

CUTTING INTEREST RATES

WEAK DATA PROMPTED the 'aggressive' Brazilian central bank in early January 2017 to cut interest rates by a larger than expected 75 basis points, writes Schroders' emerging markets economist Craig Botham.

He says this move rectifies an earlier mistake where the central bank cut rates at the previous meeting by half the level expected by the market.

ARE SHARE SPLITS A WASTE OF TIME?

THE AIM IS TO MAKE
THE PRICE LOOK MORE
AFFORDABLE, CREDIBLE
AND HOPEFULLY
IMPROVE LIQUIDITY



Have you ever seen a share price automatically shoot up 1,000% or suddenly become a fraction of the price it was the previous day? If so, these are likely to be a result of a company undertaking a share split or share consolidation.

This can involve cutting the number of shares in issue to make the share price much higher. Or more shares are issued to automatically lower a share price and make it appear less expensive.

Many companies will tell you they're trying to improve liquidity in the stock, making it easier for you to buy and sell.

In reality most are trying to make the share price seem more credible, affordable or repositioning themselves in the same price bracket as respected businesses.

Playing around with the share price by making technical changes is a psychological trick. The value of the business won't have actually changed and the value of your investment is

completely unaffected.

'Share splits are a bit of a waste of time, in my opinion,' says Stuart Andrews, head of corporate finance at stockbroker FinnCap. 'It doesn't change a company's fundamentals.'

'A share split should only be done as a last resort to improve liquidity or if the share register has become too big.'

TRYING TO HELP INVESTORS

Air Partner (AIR) is the latest company to fiddle with the number of shares in issue in an effort to make it easier to trade its stock.

The private jet specialist is swapping one old share for five new shares, thereby taking its share price from approximately 500p to 100p.

The value of the business stays the same; it simply has increased the number of shares in issue by a factor of five, so the share price automatically drops five-fold.

JD Sports Fashion (JD.) recently did a five-for-one share split after its share price had performed very well. The split made the stock look more affordable again, going from circa £16 to 320p.

'Share prices between 100p and £10 are generally regarded as sensible levels,' argues Charles Hall, head of research at stockbroker Peel Hunt.

'A very low share price can result in being seen as a "penny share"; these are generally volatile, which can also impact the perceived quality of the company. A very high share price can put off retail investors as they may be unable to buy many shares,' adds Hall.

HERE'S A COMMON MISTAKE

Let's say a company trades at £50 and you have £500 ready to invest. That cash will buy you 10 shares, ignoring any trading fees.

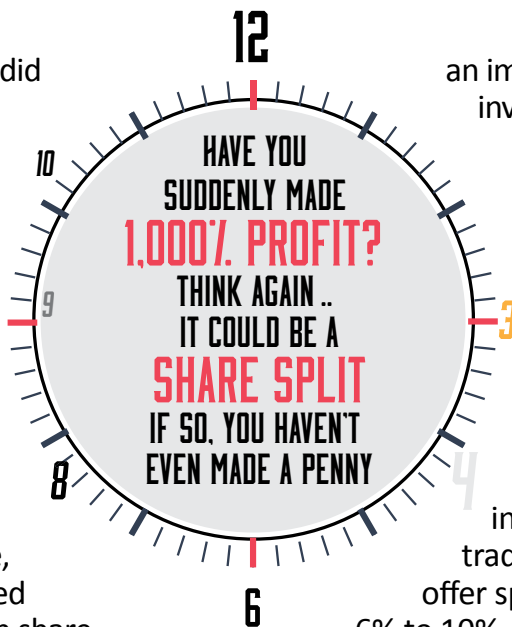
The company undertakes a 100:1 stock split which brings the share price down to 50p. Your £500 savings would now be able to buy 1,000 shares in this company.

Which would you prefer: 10 shares or 1,000 shares? Many people would opt for the latter as it seems a more substantial amount.

In reality, your investment is still worth £500 whether you bought 10 shares at £50 or 1,000 shares at 50p each.

If the shares go up 5% at *either* price (£50 or 50p), your investment goes up 5% in value in **both cases**.

'Clearly (a very high share price) should not matter, but there is a psychological barrier to buying a more expensive share and holding a relatively small number of shares,' says Hall. 'Though the absolute share price should not have



an impact, it does in reality colour investment decisions.'

IMPROVING SHARE LIQUIDITY

In Air Partner's case, we doubt anyone would feel that 500p a share was psychologically too expensive to buy, so why the share split?

The company says the real reason is down to smaller investors finding it expensive to trade its stock due to a large bid/offer spread, typically in the range of 6% to 10%.

The bid/offer spread is the difference in the price at which you can buy in the market versus the level at which you can sell. So in this example your investment must grow 6% to 10% in value just to break even when you came to sell.

Air Partner believes a smaller share price will have a tighter bid/offer spread as there would be more shares in issue and therefore more liquidity.

We don't believe that's guaranteed to happen. There are plenty of very illiquid stocks at the lower end of the market with lots of shares in issue.

Liquidity should come down to whether the company is doing something with its business for investors to want to regularly buy and sell.

MISLEADING DATA

Financial websites can take hours or even days to amend their pricing system to take into account a change in the number of shares in issue following a share split.

We've seen plenty of occasions when the published share price movement is misleading because of a share split. Some people may even think they've made 1,000% profit and hit the jackpot. They'd be wrong if there was a share split.

Royal Bank of Scotland (RBS) slumped to 20p five years ago, the kind of price often associated with high risk, immature businesses like biotech and mining exploration firms.

To get out of penny share territory, the bank gave shareholders one new share for every 10 they owned, thereby switching the share price to 200p.

Some websites showed RBS shares as rising 969% upon the share split when also factoring a small movement in the underlying share price. Alas no one got rich that day. (DC)

Alliance Trust to buy out activist investor

Elliott Associates to leave shareholder register after pushing for significant change over past few years

Previously underperforming fund **Alliance Trust (ATST)** is shifting strategy and appears to have quelled the criticism of activist investor Elliott Associates.

The Dundee-based trust has now agreed (27 Jan) to repurchase Elliott's entire 19.75% holding at a discount of 4.75% to the prevailing net asset value (NAV).

That will reduce the size of the trust, provide a 1% boost to net asset value and see annual charges move up slightly, from a maximum of 0.6% to 0.65%.

Alliance Trust will also move to a multi-manager investment strategy, tapping into the skills of numerous fund managers.

These proposals will be put to a vote at a shareholder meeting on 28 February.

PORTFOLIO TO INCREASE FROM 60 TO 200 HOLDINGS

In April 2015 Elliott led a rebellion against over the remuneration of the then chief executive Katherine Garrett-Cox, leading to the appointment of two Elliott-backed independent directors and the eventual departure of Garrett-Cox in 2016.

Elliott had also been pushing for a review of the trust's structure.

Financial services group Winterflood notes that even after paying the estimated £620m required to buy Elliott out, the trust will have assets of around £3bn.

It welcomes the board's commitment to use buybacks to ensure the NAV discount remains at the 4.75% level 'on an ongoing basis' and

adds: '(The) announcement from Alliance Trust that it has agreed to buy Elliott Associates' 19.75% stake is a major step forward for the fund.

'We were concerned that Elliott would attempt to block the board's recent proposals to adopt a multi-manager investment approach at the forthcoming general meeting. However, this threat is now removed and it allows investors to concentrate on the merits of the new approach.'

NEXT STEP

The new approach will see the in-house investment business sold to Liontrust Asset Management for £30m with consultant Willis Towers Watson overseeing the appointment of an eight-strong panel of third-party managers. Each of these managers

10-YEAR ANNUALISED TOTAL RETURN (PRICE) 8.5% AGAINST BENCHMARK 9.3%

(see table) will select a portfolio of 20 high conviction stocks, with the trust's individual holdings increasing from the current 60 to around 200.

The performance target has been doubled to 2 percentage points above the MSCI World Index net of costs on a three-year rolling period.

The strategic changes could benefit shareholders but performance needs to be delivered to justify the extra cost. (TS)

WHO WILL BE MANAGING ALLIANCE TRUST'S MONEY?

Equity Manager	Lead individual(s)	Location
Black Creek Investment Management	Bill Kanko	Toronto
First Pacific Advisors	Pierre Py and Greg Herr	Los Angeles
GQG Partners	Rajiv Jain	Fort Lauderdale
Jupiter Asset Management	Ben Whitmore	London
Lyrical Asset Management	Andrew Wellington	New York
River and Mercantile Asset Management	Hugh Sergeant	London
Sustainable Growth Advisers	George Fraise, Gordon Marchand and Rob Rohn	Stamford
Veritas Asset Management	Andy Headley	London

Source: Alliance Trust

Why we don't rate Jackpotjoy as a winner

Bingo-to-casino brands business is a losing trade, in our opinion

Bingo-led gaming firm **Jackpotjoy (JPJ)** could be worth more than 40% higher than its current 630p share price if it traded in line with the rest of the UK gambling sector.

That's according to Edison Investment which has published a research note on the £485m company following its switch from the Toronto to London stock market on 25 January.

One of the reasons behind the listing move and rebranding from its previous identity of Intertain was to trade on stock market where gambling firms had better recognition among the investment community. In essence, it wants to trade on a market where gambling stocks command a higher equity valuation.

Management should be focused on improving their business, not finding ways to push up the share price. The pursuit of 'better recognition' (aka higher valuation) is a classic red flag in investing.

Jackpotjoy's UK-listed shares now trade on 6.9 times Edison's forecast 90.8p earnings per share for 2017. Gaming analyst Jane Anscombe believes the stock will re-rate towards the sector average of 12.1 times earnings for 2017.

Canaccord Genuity has a 950p price target, also saying the company is undervalued. We think it is valued below the peer group for good reason.

Jackpotjoy operates in competitive markets against muscular rivals and also bears technology and platform risks. It has a considerable amount of debt and needs to pay a substantial amount of acquisition earn-out payments. Dividends look unlikely for at least the next few years.

Edison forecasts the company will end 2017 with £374m net debt. That equates to 77% of its current market value which could put off many investors.

'We believe there is a larger base of gaming investors in the UK which should benefit Jackpotjoy in the longer term. However, we also believe that UK investors are more sensitive to leverage than Canadian peers,' comments Canaccord.

'Historically, leverage has been quite low (or

non-existent) within the UK listed online gaming operators. By contrast Jackpotjoy carries an estimated 3.3x 2017E net debt to adjusted EBITDA, which we believe is an overhang on the stock in the near term.'

When known as Intertain, the shares were depressed by negative market sentiment linked to a scathing report of the business by a former hedge fund manager, a prolonged strategic review and adverse currency movements.



SHARES SAYS: ⚡

We don't like the high level of borrowings and the way in which the company is chasing a higher valuation. There are plenty of better stocks in the leisure sector if you want exposure to gambling, such as **GVC (GVC)**. Avoid **Jackpotjoy (JC)**

Troubled recruiter could be at a turning point

Financial results in March may show a considerable improvement following years of turmoil

Recruitment agency and management consultant **Parity (PTY:AIM)** looks more interesting after an internal shake-up. Profit margins and cash generation are improving and we believe it may soon sell a non-core business, the proceeds of which could help repair its weak balance sheet.

Parity's founder Philip Swinstead returned to the business in 2010 and tried to turn it into a digital media agency. The £9.8m cap business made several acquisitions which flopped. It wasted further money on due diligence for potential acquisitions but lost out to rival firms who acted faster.

The share price has been constrained by frustrated investors selling into any rally in a bid to reduce their holdings.

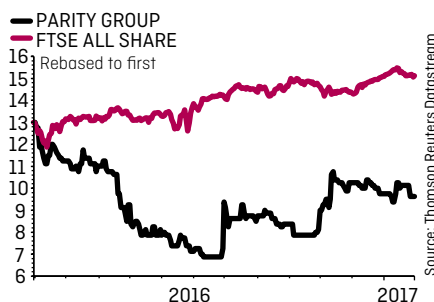
The group has spent years strangled by debt and pension obligations. It is making headway trying to fix these problems. Net borrowings were £6.5m as of mid-2016. The company has negotiated lower payments into its pension scheme which has a £1.6m deficit. It is unlikely to pay dividends in the near future, in our opinion.

DIFFERENT THIS TIME?

Changes have been made to the way the business operates with the consultancy arm now the growth driver thanks to higher profit margins than plain recruitment.

Some of Parity's biggest consultancy jobs are in the utilities sector, helping the water companies prepare for deregulation.

From April this year businesses in England will be able to select their own water provider, just like the electricity and gas market. That's prompted the water industry to need



more staff to ensure billing systems are up to scratch, pipes are fixed and data can be managed properly.

It also does a lot of work in the defence and health sectors. Specialist consultants are found via Parity's recruitment division to undertake project work via its consultancy arm. Clients are happy as Parity's fees are half that charged by the big consultants such as KPMG.

POTENTIAL ASSET DISPOSAL

Parity has told *Shares* it might sell a small division called Inition. Once a struggling 3D printing business living off £200-a-go contracts, Inition has become more successful in the topical field of virtual and augmented reality.

Management said any proceeds would be used for debt repayment and investment into the consultancy division.

SHARES SAYS:

Currently trading at 9.75p, Broker Investec believes the shares will jump 50% and hit 15p by the end of the year, saying it can't 'it cannot fly under the radar forever'. Parity is certainly looking interesting after a long period of underperformance. However, we want to see more evidence of both operational and financial improvement before turning bullish on the shares. (DC)

OPG withstands blows

Indian operator can recover from short-term setbacks

A series of unfortunate events in the Tamil Nadu area of India will cap output at the Chennai-based power projects of **OPG Power Ventures (OPG:AIM)**.

This implies a £5m to £6m shortfall in revenue for the year to 31 March 2017 and is acting as a deadweight on the share price, which has fallen more than 8% to 57p.

But *Shares* remains convinced that these are no more than short-term setbacks and that the medium to longer-term investment case stacks up as attractively.

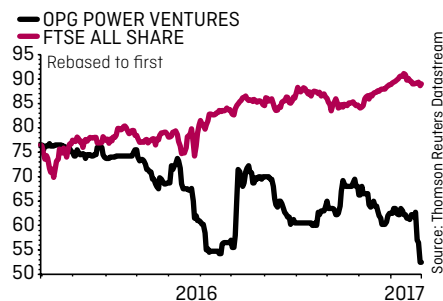
The trouble started in November when the Indian government pulled 500 rupee and 1,000 rupee bank notes out of circulation in a counterfeiting crack down. That created cash shortages across the nation and has stymied consumer spending.

Economic activity was further curtailed in early December following the death of Jayalalitha Jayaram, the chief minister of India's southern Tamil Nadu state, sparking widespread mourning in the region.

These problems were compounded just days later as Cyclone Vardah lashed Tamil Nadu, killing several people and halting normal activity and hitting power supplies and demand.

Cantor Fitzgerald analyst has pulled forecasts temporarily until the impact of these issues, and recent coal pricing declines, can be worked through. But he does conclude that these events are largely one-offs and 'should not detract significantly from the investment case.'

Revenue of roughly £215m had been anticipated this year, according to Reuters data.



SHARES SAYS: ↗

We continue to support the growth and income investment case, this looks a good buying opportunity.

Brainjuicer squeezes out the profit

A STRONG FINISH to 2016 is set to see market research agency **BrainJuicer's (BJU:AIM)** full year performance come in well ahead of expectations. Gross profit is anticipated up 27% on US progress and the start of a recovery in Continental Europe. Higher margin Advertising Testing and Brand Tracking services are increasing in the business mix and with tight control exercised over costs, pre-tax profit is seen 37% higher at £6.2m year-on-year. [TS]

Stick with Wynnstay

PATIENT INVESTORS who have persevered with agricultural inputs supplier-to-specialist retailer **Wynnstay (WYN:AIM)** through the agri-sector downturn have been rewarded with a rally to 542.5p. *Shares* remains supportive of the income stalwart. Full year results (25 Jan) included an 8% dividend hike in the shareholder reward to 12p and news of recent recovery in dairy sector farmer output prices following sterling devaluation. [JC]

Sopheon could double

DATA SUGGESTS **Sopheon's (SPE:AIM)** share price could double if it continues its re-rating towards a sector average 12.6-times enterprise value (EV) to earnings before interest, tax, depreciation and amortisation (EBITDA). Shares in the lifecycle management software minnow have soared 482% in 12 months but that still implies an EV/EBITDA of just 6.2-times. Analysts at house broker FinnCap have put their previous 360p target price under review. [SF]

Are special situation funds unique?

Investment fad has led to an identity crisis



Special situation investment strategies are either considered to be the ultimate in active fund management or vanity projects for show-off stock pickers.

They were all the rage about a decade ago after an 18 year run of super performance by **Fidelity Special Situations Fund (GB00B88V3X40)**, then headed by star investor Anthony Bolton.

That led to something of an investment fad in the sub-sector, with many fund management firms rebadging themselves as special situations mavericks. Cynics claim such moves were little more than a marketing ploy.

What began as a remit for investing in recovery or turnaround stories, buying potential takeover targets or possible demerger situations,

has ultimately broadened and became more nebulous.

ARE THESE FUNDS REALLY THAT DIFFERENT TO MAINSTREAM ONES?

A few special situations funds say their objective is to find unrecognised growth potential. That's really just a broad brush stroke description of investing in general.

Artemis UK Special Situations Fund (GB00BB36JR17), for example, say it looks for 'unrecognised growth potential in companies, often those that are unloved or out-of-favour'.

Managers Derek Stuart and Andy Gray see 'problem investments' as a rich seam of opportunity because of the inherent potential for substantial returns if a struggling

company successfully pulls-off a turnaround.

Fidelity fund manager Alex Wright looks for 'unloved companies entering a period of positive change that the market has not yet recognised'.

That echoes the Artemis point that 'if things unexpectedly improve, there is significant upside as the consensus view changes and new investors buy into the story'. One could also suggest the downside could be limited if the story is out of favour in the first place.

Alastair Mundy, who runs the **Investec UK Special Situations Fund (GB00B1XFJS91)**, eschews the apparent identity crisis some associate with the space. 'I'm not sure they are supposed to *be* anything,' he says, adding that it doesn't really matter.

ATTRACTIVE PERFORMANCE STATISTICS

While it is easy to be critical of what the name ‘special situations’ has become, its appeal is obvious when you look at the performance statistics.

As the accompanying table shows, you could have made at least 10% annualised returns over the last decade plus 30%+ last year with certain products.

TOP 5 SPECIAL SITUATION FUNDS IN 2016	
Investec Global Special Situations	37.8%
Fidelity American Special Situations	33.9%
Liontrust GF Special Situations	33.0%
Fidelity Asian Special Situations	28.5%
BlackRock Asia Special Situations	27.9%

Source: Morningstar

TOP 5 SPECIAL SITUATION FUNDS, 10 YRS ANNUALISED	
Fidelity American Special Situations	12.4%
Marlborough Special Situations	12.1%
Liontrust Special Situations	11.8%
Fidelity Asian Special Situations	11.1%
BlackRock European Special Situations	9.9%

Source: Morningstar

WAITING FOR BIG SELL-OFF BEFORE BUYING

Mundy hunts for stocks which have fallen at least 50% from their highest point. He’s looking for situations where investors have ‘given up hope’ and expectations are largely for the company to fade away.

It’s at that point that he

mobilises his research team to conduct ‘a lot of fundamental analysis.’

Can the conventional wisdom be challenged? If yes, he might invest. It’s a risky strategy that Mundy freely admits often doesn’t pay off. When it does, the returns can be more capable of offsetting the misses.

Perhaps the key to understanding this sub-sector is demonstration rather than explanation, namely looking at the stocks being added to portfolio.

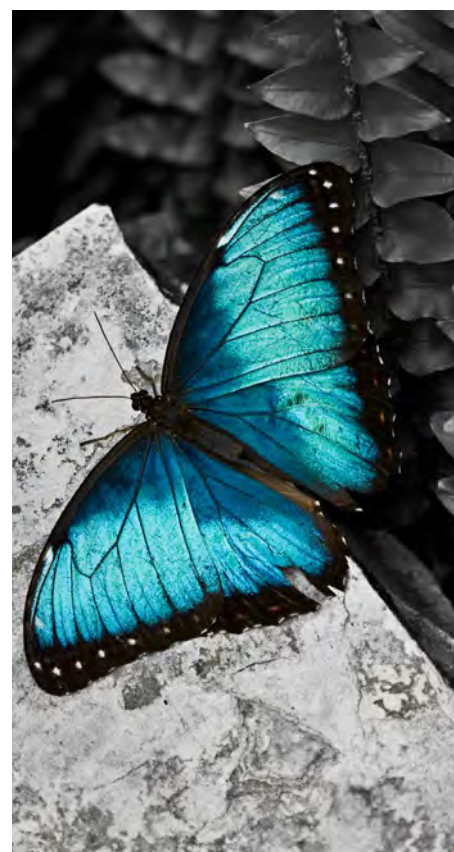
There is certainly some common ground among the Special Situations managers. Most seem to massively favour domestic UK shares and oil stocks, largely shunning overseas opportunities unless foreign markets are a fundamental part of their strategy.

There also tends to be a natural bias in favour of mid and small cap stocks, although this is not true across the board.

BANKS ARE POPULAR AMONG SPECIAL SITUATION FUND MANAGERS

Fidelity’s Alex Wright’s believes that banks still look cheap on a historical basis, with valuations on some hitting financial crisis lows following last summer’s EU referendum despite ‘improved balance sheets, cleaner loan books and a healthier earnings.’

Wright holds banks on the basis that market valuations have yet to catch up with earnings, while rising interest rates would add support as this tends to prop-up net interest margins. This has played out fairly well recently, his holding in **Citigroup (C:NYSE)** saw its



shares run up strongly ahead of December’s US Federal Reserve rate increase.

Construction and the oil industry are other areas popular now with Wright, with **CRH (CRH)** flagged as a possible play on Donald’s Trump’s Mexican wall, while **Royal Dutch Shell (RDSB)** is his fund’s biggest single stake.

Investec’s Mundy has his eyes trained currently on the UK high street and consumers, areas yet to feel any meaningful pinch from rising wages and cost inflation judging by October to December Office of National Statistics consumer spending data.

But the situation might be very different in a year’s time. Retailers may be dealing with the fallout of lower footfall and not as much cash going through the tills. Mundy’s keeping a watching brief. (SF)

Top deals on the retail bond market

You don't need to buy bonds when they are first issued to make a profit



Income investors looking for a higher yield might want to allocate part of their portfolio to retail bonds. These are available from many well-known UK companies with some paying in excess of 5% or 6% per year. Familiar names issuing bonds include Aviva, Severn Trent, Tesco and Unilever.

HOW DO YOU BUY THEM?

Investors can buy the bonds via their stockbroker in the same way as buying individual company shares and when held in an ISA or SIPP (self-invested personal pensions) the interest would be tax-free.

You can apply for the bonds when they are first issued or buy them after they have started trading. They are issued at par or face value and will be redeemed at the same level on maturity, as long as the issuer doesn't

run into financial difficulties. At all other times the prices will fluctuate.

Admittedly there have only been a small amount of new retail bonds issued over the past few years; however, there are still plenty of previously-issued bonds which you can buy on the open market and which pay a decent level of income.

WHAT ARE THE RISKS WITH BONDS?

The three main risks for bond holders are:

- 1** Interest rates could rise and force the bond prices lower as investors move their money elsewhere.
- 2** A lack of liquidity could mean that you can't sell the bonds when you want to.
- 3** The bond issuer could run into financial difficulties and miss a coupon (interest)

payment or go bust.

Patrick Connolly, a certified financial planner at Chase de Vere, says many investors want a competitive level of income without putting their underlying capital at undue risk. 'Against this backdrop the returns on retail corporate bonds can appear attractive,' he says.

'However, investing in a single company is a high risk approach. We have seen how even supposedly strong and secure companies such as the high street banks can get into financial difficulties.'

Despite this warning, we believe bonds can still be good investments as long as you understand and are comfortable with the risks.

HOW MUCH COULD I GET EACH YEAR?

People mainly buy retail bonds

for the income, which is paid via an annual or semi-annual coupon at a pre-set time in a pre-set amount. You can assess this by looking at the flat or running yield that is calculated by dividing the total annual coupon by the current price.

If you invest after a bond has already started trading, the price is likely to have moved above or below the par value, which means that you will make a capital loss or gain if held to maturity.

This is reflected in the 'yield to maturity', which calculates the effective annual return. It is still possible to make money even if you buy a bond above its original issue price.

HOW TO CALCULATE YOUR RETURNS

Russ Mould, investment director at AJ Bell, says that investors looking for a short-term holding, perhaps to combat rising inflation, should consider the 6.25% 2019 bond from property developer St Modwen that trades under the ticker SMP1.

The numbers in the product name refer to the annual return based on the bond's issue price, and the year in which the bond is wound up and you get your original capital paid back.

'The St Modwen bond in question matures on 7 November 2019 and trades



at around 106p, so the yield to maturity is 4.1%,' explains Mould.

When interest rates go up it makes the coupons from bonds less attractive and investors tend to sell, driving the price lower and the yield higher until it becomes competitive again. This is less of a concern with issues like the St Modwen bonds as they only have a short time to go until maturity when you get the face value back.

An investor who bought 10,000 of these bonds at the current 106p price would have to pay £10,600 and would lock in a capital loss of £600 if held to maturity in November 2019. The reason they may still want to buy the bonds despite a capital loss is down to the interest (or coupon) payments.

The investor would be entitled to the six remaining six monthly coupons of 3.125% (half of the annual coupon of 6.25%) or £312.50. That would give them £1,875 through coupon payments. When the bond matures in 2019, you would

get £10,000 paid back by St Modwen, being the value of the original bonds as if you'd bought them when first issued at 100p.

Your capital loss is therefore £10,600 (amount you paid) minus £10,000 (amount paid back by St Modwen) = £600. However, you then take into the £1,875 received through the coupon payments. So £1,875 minus £600 = an overall profit of £1,275.

TESCO BOND ALSO WORTH A LOOK

Another product to consider is the 6% 2029 Tesco bond. We think the supermarket is back in good health following previous trading and cultural problems. We're confident the company will be able to pay back bondholders in 2029 and maintain regular coupon payments in the interim.

Tesco's bond trades under the ticker 400S and is priced well above the par value at 110p, but even after factoring in the capital loss when the paper redeems at 100p the yield to maturity is still just under 5%.

An investor who bought 10,000 of the bonds would have to pay £11,000 and would earn an annual coupon of £600 every year until they mature in December 2029, whereupon they would get back the face value of £10,000. (NS)



Brace yourself for state pension turbulence

When will you get the cash and how much will you get?

When do you think you'll receive your state pension and how much will you get? In an ideal world retirement investors would like to know the answers to these two questions.

The UK state pension system is fiendishly complicated and riddled with uncertainty. As a result, you might feel like you're fumbling in the dark trying to figure out the foundation on which your private retirement savings are built.

I can at least help shed some light on how much you will get. Under reforms introduced in April 2016, future retirees are entitled to a flat-rate state pension worth around £155 a week.

THERE IS ALWAYS A CATCH

Not everyone will get the full amount. In order to qualify for the full state pension entitlement, you need to have 35 qualifying years of National Insurance (NI) contributions. To get any state pension, you'll need at least 10 years of NI contributions.

You can receive NI credits if you claim child benefit for a child under 12, get Jobseeker's Allowance or receive a Carer's Allowance. These will count towards your state pension qualifying years.

The value of your state pension might be lower if you previously



contracted-out of the additional state pension (sometimes referred to as 'S2P'). More details on how the new state pension works can be found on [this Government website](#).

WHEN WILL I GET THE CASH?

Exactly when you will receive your state pension is likely to be the subject of significant debate in 2017. John Cridland, the former director of the CBI, is leading a review of the state pension age which could be a precursor to fundamental, radical reform.

At the moment, most people get their state pension at age 65. This is scheduled to rise to 66 from 2018, 67 from 2026 and 68 from 2044.

The debate around the state pension age centres on the balance between fairness and simplicity. Giving everyone the same amount at the same age is easy to understand and administer, but those on higher

incomes tend to live longer and so will benefit more. Is this right? Or should the rich get their state pension later?

Equally, there are significant regional differences in life expectancy. According to the ONS, a 65 year old man in Kensington can expect to reach their 86th birthday, while a 65 year old in Manchester can only expect to clock up 80 years.

Incorporating things like income and region into the state pension age calculation might be possible, but would add untold complexity to an already complicated system.

As you plan for your retirement, you should prepare for the worst. Whether the Government pursues radical reform or maintains the existing structure, in reality you will probably have to wait longer to receive your state pension.

TOM SELBY,
senior analyst, AJ Bell



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KEY

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- **AIM**
- **Overseas Market**
- **Fund**
- **Investment Trust**
- **Exchange-Traded Product**

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