SIMON LAFFIN INDEPENDENT RETAIL ADVISER AND NON-EXECUTIVE DIRECTOR

Seeking the value in retail shares

My financial adviser recently asked me what retail stocks he should buy. Hang on, I said, I pay you to make the investment decisions for me. However, I gave it some thought and suggested in general buying quality businesses and good cash flow, rather than cheap stocks in the hope of value gain. We discussed Sainsbury's and then moved onto Ocado. If I were to invest in retail, he wanted to know, which stock would I prefer to buy?

Sainsbury's is valued on the stock market at £7.5bn, whereas Ocado is at £2.3bn. So Sainsbury's is apparently worth three times Ocado. However, Sainsbury's is expected (by Barclays) to make a net income, after tax, of £632m this year, Ocado to make a small pre-tax loss. Sainsbury's will pay out some £330m in dividends this year to its shareholders, whereas Ocado seems to have no expectation of a dividend in the foreseeable future. Sainsbury's is forecast to have an expected free cash flow over the next nine years of £5.2bn, Ocado £400m.

So what do you have to believe about the future prospects for these companies in order to persuade yourself to buy an Ocado share instead of a Sainsbury's one? Firstly, as Ocado pays no dividend, you must be looking for share price appreciation, rather than income. Sainsbury's has a price earnings (PE is market capitalisation divided by net income) ratio of 11.9x, not an untypical ratio for a quoted stock. Ocado cannot have an equivalent as it doesn't make a profit. To match Sainsbury's PE ratio on its own market capitalisation, Ocado would have to have a net income today of £193m. On its annual sales of £800m, this would require a net income margin of 24%. Sainsbury's equivalent is 2.6%, Morrisons' 3.2% and Tesco's 4%.

Ocado pays no dividend so a decision to buy would be based on future growth

"A DIVIDEND IS CASH IN HAND AND FUTURE GROWTH IS JUST A PROMISE"

But you'd buy Ocado for its future growth, not its current performance. If we look three years out, Sainsbury's is forecast to earn £728m net income (a forward PE of 10.3x). A similar forward PE for Ocado would suggest a net income of £223m. Perhaps you would be happy to forego any dividend payments in the next few years for Ocado's better future growth prospects after that? But don't forget that a dividend is cash in hand, and future growth is just a promise.

So looking at future growth, what probability would you apply to Sainsbury's earning £728m in three years against Ocado earning £223m? Barclays is currently forecasting that Ocado will achieve £31m that year.

Now I'm not saying that Ocado is not a great business. It's achieved a tremendous amount, not least its deal with Morrisons. I'm simply answering the question where would I invest my hard-earned pension pot at current prices. There are, of course, equally interesting valuation disparities in general retail; Asos (PE 92.4x and no dividend) versus Debenhams (PE 9x) or Marks & Spencer (PE 16.1x).

Of course the art of valuation is also about guessing what others think the value is. The great economist John Maynard Keynes said: "Markets can remain irrational a lot longer than you and I can remain solvent." This was probably a rueful remark as Keynes invested on the stock market and lost large amounts of money almost as often as he gained them. I think I'll leave investment decisions to the experts.