Investors' Chronicle | Alpha

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AlphaScreens: the market according to GARP

11 May 2023

Cyclical shenanigans versus genuine cheap growth

Growth at a reasonable price, or GARP, has proved a reliable strategy that has previously generated market-beating returns. Growth forecasts are facing something of a reckoning and value principles are back in fashion. We're not there yet, but we're keeping a watch on the GARP style of investing that combines elements of both.

Comment by Alpha editor:

- Growth at a reasonable price (GARP) screening can be caught out by cyclical factors and the mining industry is a prime example. Copper producer **Antofagasta (ANTO)** is the only UK large cap to pass our threshold of seven out of nine tests, but the share price has been drifting lower as have earnings growth assumptions when comparing the FactSet consensus data to when we last ran the screen. That means, on a forward price to earnings growth (PEG) ratio, the stock is relatively more expensive even though the share price is lower. Thanks to the weighting of share price to trailing earnings in the other PEG (the 'genuine value', see below) ratio that we use, ANTO, confusingly, looks slightly cheaper than before. The moral of the story is that mining company earnings are very lumpy and, therefore, our screen probably isn't the best tool for timing an investment into cyclicals, or is it? Undeniably, there is a strong long-term need for copper: when the moderation of earnings forecasts made at the last peak is done, checking when the forward PEG and Genuine Value ratios are both attractive next to long-run averages could be a decent entry point.
- GARP investing really comes into its own when valuing companies with a much smoother earnings growth trajectory. Big tech would have come into that category over most of the past decade and it is interesting to see **Meta Platforms (US:META)**, formerly known as Facebook) ranking highly on our S&P 500 screen. The share price has risen a third in the last three months as Big Tech stocks recovered ground from the 2022 sell-off. Investors may have been lukewarm on the company's big metaverse pivot but are perhaps keener on the noises it's making on 2023's biggest buzz technology, artificial intelligence. As discussed by Arthur Sants in his feature article last month, Meta is staying out of the bunfight

over search engines and instead using AI to focus the experience of social media users and improve advertising targeting and engagement. That focus on the core revenue-generating business may be music to investors' ears, albeit requires substantial capex. More immediately, the fact Meta fails our test of year-on-year earnings growth for the last two quarters, is testament to the maturity of those core business operations and their sensitivity to tougher economic conditions.

- Top of our Aim screen, Zoo Digital (ZOO) is forecast to achieve massive earnings growth (it fails our earnings growth test because the average EPS growth expected over the next two years is flagged as high enough to warrant a double-take). Alongside the organic growth for Zoo's specialist localised cloud services for entertainment streaming services - which helps meet challenges of disseminating content to global audiences - the company has an aggressive investment and acquisition strategy. Most recently, the company has been tapping equity markets for funding to acquire a partner business in Japan, which is currently the subsidiary of a Japanese technology company. The capital raise was an oversubscribed £12.5mn new shares placing alongside a £0.16mn retail offer to existing investors. The issue price was at roughly a 13.5 per cent discount, and Progressive Equity Research estimates the increased share count will have a four per cent dilutive effect on 2024 earnings per share. These factors account for the market value pulling back, although the shares are still up by more than a quarter on a year ago. Investors' main questions should focus on those growth projections. The PEG ratios suggest it is very cheap, so further research here should centre on the diversity of the customer base and the nuts and bolts of revenue streams. Success and making good on the spectacular confidence of broker forecasts depends on relationships with the big content streaming services and whether Zoo can continue to grow its market share.

All latest GARP screen results are below

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UK large-cap GARP selection (passing at least 7 out of 9 tests)

Name	Ticker	Share price (p)	Mkt Cap (£mn)	Fwd 12-mth PE	3-yr PEG	PEG (Neff)	EV/ Ebitda	Trailing 12-mth DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 9)	Tests failed
Antofagasta	ANTO	1439	14191	21.9	1.6	0.4	7.5	3.4%	32.8%	1.3%	-14%	652.9	7	HY +ve EPS/Fwd PEG < 1/

Source: FactSet, Investors' Chronicle

UK mid-cap GARP selection (passing at least 7 out of 9 tests)

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd 12-mth PE	3-yr PEG	PEG (Neff)	EV/ Ebitda	Trailing 12-mth DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 9)	Tests failed
Howden Joinery	HWDN	699	3860	13.8	-	-8.3	8.0	2.9%	-25.1%	8.7%	-1%	-233.2	7	Av FY2 Fwd EPS growth > 7.5%/Fwd PEG < 1/
OSB Group	OSB	490	2088	4.9	0.6	0.5	-	6.2%	-2.5%	9.8%	-13%	-	7	Mid PE/Av FY2 Fwd EPS growth > 7.5%/

Source: FactSet, Investors' Chronicle

UK small-cap GARP selection (passing at least 6 out of 8 tests)

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd 12-mth PE	3-yr PEG	PEG (trail)	EV/ Ebitda	Trailing 12-mth DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	Av EPS gr FY*2	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 8)	Tests failed
Foresight Group	FSG	425	494	11.2	0.4	0.24	12.7	3.4%	49.6%	8.7%	29.2%	-8%	-	8	na
Baltic Classifieds	BCG	164	814	20.9	0.1	0.03	23.9	1.2%	1575.2%	12.5%	793.8%	10%	9.3	7	/EPS Gwth/
EnQuest	ENQ	16	306	1.5	1.0	0.21	1.3	0.0%	8.8%	34.9%	21.9%	-26%	-656.4	6	/Mom or Upgrade/
Braemar	BMS	283	93	7.9	0.3	0.08	6.1	3.9%	132.6%	-15.5%	58.6%	-12%	-28.9	6	/EPS Gwth/RoE or margin/
Seplat Energy	SEPL	97	572	3.6	0.1	0.04	1.7	13.1%	166.7%	35.1%	100.9%	-11%	-141.0	6	/EPS Gwth/Mom or Upgrade/
Ricardo	RCDO	580	361	15.6	0.3	0.14	6.8	1.9%	148.8%	15.6%	82.2%	6%	-62.8	6	/EPS Gwth/RoE or margin/
Centamin	CEY	109	1267	11.8	1.1	0.25	4.8	3.8%	87.9%	-9.4%	39.3%	9%	-0.4	6	/EPS Gwth/
Hochschild Mining	HOC	80	411	8.8	0.0	0.05	3.4	0.0%	570.1%	194.1%	382.1%	23%	-58.6	6	/EPS Gwth/RoE or margin/

Source: FactSet, Investors' Chronicle

UK Aim GARP selection (passing at least 6 out of 8 tests)

Name	Ticker	Share price (p)	Mkt cap (£mn)	Fwd 12-mth PE	3-yr PEG	PEG (trail)	EV/ Ebitda	Trailing 12-mth DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	Av EPS gr FY*2	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 8)	Tests failed
ZOO Digital	ZOO	140	137	17.5	0.2	0.17	15.1	0.0%	119.4%	50.3%	84.8%	-18%	-18.0	7	/EPS Gwth/
Argentex	AGFX	120	136	12.0	0.2	0.41	3.1	1.0%	33.2%	30.5%	31.9%	-8%	-	7	/Mom or Upgrade/
H&T Group	HAT	446	196	7.5	0.2	0.16	4.9	3.4%	48.2%	22.6%	35.4%	-1%	-1.5	7	/Cash Conv/
Jubilee Metals	JLP	8	229	8.5	0.7	0.42	7.1	0.0%	40.4%	0.0%	20.2%	-29%	-47.7	6	/EPS Gwth/Mom or Upgrade/
Tribal	TRB	40	85	11.9	0.1	0.04	9.8	3.3%	452.0%	3.9%	228.0%	-24%	-37.7	6	/EPS Gwth/Mom or Upgrade/
Serica Energy	SQZ	230	881	2.5	-	0.06	0.4	9.6%	50.6%	1.2%	25.9%	-13%	186.7	6	/3yr PEG<1/Mom or Upgrade/
Yu Group	YU	610	102	11.1	0.3	0.09	3.2	0.5%	58.4%	44.3%	51.3%	-11%	-54.9	6	/EPS Gwth/Cash Conv/
tinyBuild	TBLD	54	110	8.4	0.4	0.31	11.6	0.0%	37.8%	7.8%	22.8%	-8%	5.1	6	/RoE or margin/Mom or Upgrade/
Vertu Motors	VTU	60	209	5.4	0.6	0.34	5.0	0.0%	24.3%	8.3%	16.3%	-8%	-737.4	6	/RoE or margin/Debt to Ebitda/
Atalaya Mining	ATYM	355	497	7.3	0.1	0.16	8.3	0.0%	93.5%	56.0%	74.7%	-3%	-16.9	6	/EPS Gwth/RoE or margin/
Eagle Eye Solutions	EYE	537	157	39.6	0.3	0.17	25.1	0.0%	504.8%	24.0%	264.4%	-1%	-8.6	6	/EPS Gwth/RoE or margin/
Hurricane Energy	HUR	7	149	6.2	10.4	0.01	0.7	0.0%	337.2%	-55.4%	140.9%	2%	-24.6	6	/EPS Gwth/3yr PEG<1/
Eckoh	ECK	43	125	21.2	0.3	0.15	17.0	1.6%	274.5%	5.2%	139.9%	4%	-16.1	6	/EPS Gwth/RoE or margin/
Microlise	SAAS	122	142	28.6	0.3	0.43	20.2	0.0%	246.2%	15.7%	131.0%	9%	-13.3	6	/EPS Gwth/RoE or margin/
Billington Holdings	BILN	440	57	8.8	-	0.40	6.0	3.5%	29.4%	-2.6%	13.4%	31%	-10.9	6	/EPS Gwth/3yr PEG<1/

Source: FactSet, Investors' Chronicle

US S&P 500 GARP selection (passing at least 8 out of 9 tests)

Name	Ticker	Share price ($)	Mkt cap ($mn)	Fwd 12-mth PE	3-yr PEG	PEG (Neff)	EV/ Ebitda	Trailing 12-mth DY	Fwd EPS grwth cur. FY	Fwd EPS grwth next FY	3-mth share price mom	Net cash ($mn)	Tests passed (out of 9)	Tests failed	Sector
Booking Hldgs	BKNG	2645.92	97723	18.3	0.6	1.1	17.0	0.0%	36.1%	18.2%	13%	3952.0	9	na	Other Consumer Services
Meta Platforms Class A	META	233.08	518781	18.4	0.5	1.2	13.7	0.0%	35.9%	24.5%	34%	14006.0	8	/Q +ve EPS/	Internet Software/Services
Lamb Weston Hldgs	LW	111.62	16264	22.5	0.5	0.5	18.7	0.9%	116.4%	10.7%	12%	-174.1	8	/5yr EPS gwth/	Food: Specialty/Candy
Juniper Networks	JNPR	29.07	9349	12.0	0.9	1.2	12.1	2.9%	20.4%	10.1%	-7%	-973.3	8	/5yr Rev grth/	Information Technology Services
Chubb	CB	200.47	83030	10.6	0.6	1.0	-	1.7%	19.7%	11.0%	-7%	-	8	/Q +ve EPS/	Property/Casualty Insurance
Allegion	ALLE	108.31	9526	15.8	1.2	1.2	14.6	1.6%	17.7%	7.1%	-8%	-415.6	8	/Fwd PEG < 1/	Building Products
VICI Properties	VICI	32.55	32688	13.1	0.4	0.3	24.7	4.7%	92.3%	4.8%	-6%	-	8	/5yr EPS gwth/	Real Estate Investment Trusts
Deere & Company	DE	380.39	112718	12.1	0.9	0.5	12.3	1.2%	31.3%	5.0%	-9%	-27617.0	8	/5yr EPS gwth/	Trucks/Const'n/Farm Machinery
Caterpillar	CAT	213.17	109979	11.9	0.8	0.4	11.0	2.3%	27.5%	3.0%	-14%	-24527.0	8	/5yr EPS gwth/	Trucks/Const'n/Farm Machinery

Source: FactSet, S&P 500, Investors' Chronicle

Finding that magic combination of value and growth

Buying shares that offer growth at a reasonable price (GARP) can generate strong returns. Prominent exponents of this style of investing include the likes of Jim Slater, Peter Lynch and, arguably, also John Neff.

A key metric to assess whether companies offer the magic combination of value and growth is the price/earnings-growth (PEG) ratio. In its most basic form, the ratio simply compares a share's valuation against its earnings with its earnings growth rate (historic or forecast). This approach is not overly exacting, but over many years it has proved a very effective way of identifying great investment opportunities when combined with other factors that suggest there are solid foundations to the value and growth measures used by the ratio.

Large-cap GARP criteria

We run our large-cap GARP criteria against the S&P 500 for US companies and for UK companies, we use the tests (listed below) against a universe of the top 80 per cent of the UK's market capitalisation.

We also run these tests against UK mid-cap stocks – which we are defining as from the 80th to the 95th percentile of size by market capitalisation.

The screen methodology uses a PEG ratio based on the historic price/earnings (PE) ratio divided by a combination of the earnings growth rate and dividend yield. The earnings growth rate is calculated based on the average of the five-year historic growth rate and the average forecast growth over the next two years.

As well as this PEG test, which includes some backward-measures, we have also an exclusively forward-looking PEG. The PE in the numerator is the ratio of current share price to expected earnings per share two years ahead of the current unreported year. The growth rate in the denominator is the compound annual growth rate between last reported earnings and the expected earnings at the end of the period. A figure below one suggests that a company is cheaply valued relative to its expected earnings growth.
The large-cap screening criteria are:

- A PEG ratio below the median average.
- A three-year forward PEG below one.
- A PE ratio that is higher than that of the lowest quarter of stocks screened (i.e. not suspiciously cheap) and below the top quarter (i.e. not dangerously expensive).
- A five-year historic EPS compound annual growth rate above 7.5 per cent, but below 20 per cent (i.e. high, but sustainably so).
- A five-year historic revenue compound annual growth rate above 5 per cent (i.e. sales growth underpinning earnings growth).
- Year-on-year EPS growth in each of the past two half-year periods.
- Average forecast EPS growth of more than 7.5 per cent for the next two financial years.
- Positive free cash flow in each of the past three years.
- No downgrade to forecast EPS over the past three months.

Not many stocks pass such a stringent list of criteria. All stocks must pass the historic PEG test to feature in the table. While the primary ranking of the stocks is based on the number of tests they pass, inside each of these groupings, stocks are ordered according to their attractiveness based on a combination of PEG and three-month price momentum.

Small-cap GARP criteria

Our small-cap GARP screen is run against stocks in the bottom five per cent of the UK main market by size but with a lower cut-off of £35mn introduced to exclude the most illiquid shares.

We use the same small cap rules to screen the UK's Aim.

The small-cap screen uses a PEG based on the historic PE ratio and average forecast growth for the next two financial years. The screening criteria are:

- A PEG ratio in the bottom quarter of all stocks screened.
- A three-year forward PEG below one.
- EPS growth forecast for each of the next two financial years and an average growth rate over the period of more than 10 per cent and less than 50 per cent (i.e. high, but sustainably so).
- Either a return on equity (ROE) of over 12.5 per cent or an operating margin of over 15 per cent (i.e. an indicator of a quality business that may have a sustainable advantage).

- Either three-month share price momentum better than the median average or earnings upgrades of 10 per cent or more over the past three months (i.e. recent reasons to feel positive).
- Operating cash conversion of 90 per cent or more.
- Net debt of less than 1.5 times cash profits.
- A market capitalisation of more than £10mn (i.e. not severely illiquid).

Not many stocks pass such a stringent list of criteria. All stocks must pass the low blended PEG test to feature in the table. While the primary ranking of the stocks is based on the number of tests they pass, inside each of these groupings, stocks are ordered according to their attractiveness based on a combination of PEG and three-month price momentum.

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ISSN 0261-3115.