Investors' Chronicle | Alpha

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AlphaScreens: the market according to GARP

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Growth, cyclical and mild re-rating potential

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:

- The share price of miner **Antofagasta (ANTO)** has risen 9 per cent since we last ran our growth at a reasonable price (GARP) screen and could be well placed to rise further if China's new round of credit easing helps stimulate copper prices. Antofagasta remains the only large-cap UK company to meet our inclusion threshold of passing seven out of nine GARP tests and thanks to a slight improvement in mean broker forecasts is now slightly cheaper than a month ago on a price to forecast earnings growth (PEG) measure. Strictly speaking, miners are too cyclical for GARP to be the main consideration and it is telling that analysts are split in their views on ANTO - of 17 analysts surveyed (ahead of China credit easing news) in FactSet data, seven have turned more positive on FY 2023 earnings estimates, four have maintained their position and six have turned more negative; 13 have the company on a hold and only two on a buy.

- Among smaller UK companies, asset management firm **Rathbones (RAT)** passes all our tests. For the current financial year the mean forecast is for 51 per cent earnings per share growth, with just under 23 per cent the following year. This is a company that has disappointed forecasters in recent years, however and risks to matching more bullish predictions come from the accuracy of assumptions about how earnings accretive past acquisitions will be once bedded in; there are also ongoing investments in IT, a factor that has dragged on margins in recent years.

- For a true 'growth' stock we have Aim-listed **Gaming Realms (GMR)**, which develops and licences mobile focussed gaming content. Real money gaming - effectively a form of online gambling - drives revenue, so regulatory risks would need to be assessed here. Just looking at our screen metrics as a starting point, however, and the stock is priced cheaply relative to the positive outlook for profit growth. But as ever, stock screens are only an idea generator and more analysis must be undertaken.

June 2023 GARP results

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	1570	15473	24.0	1.5	0.4	8.0	3.1%	30.7%	4.0%	9%	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 next FY	3-mth share price mom.	Net cash (£mn)	Tests passed (out of 9)	Tests failed
OSB Group	OSB	519	2200	5.1	0.6	0.5	-	5.9%	-2.5%	9.8%	9%	-	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
Rathbones	RAT	1944	1233	13.9	0.4	0.39	-	4.3%	51.1%	22.7%	36.9%	5%	-	8	na
Baltic Classifieds	BCG	165	818	21.1	0.1	0.03	24.0	1.2%	1549.1%	12.5%	780.8%	10%	9.3	7	/EPS Gwth/
Seplat Energy	SEPL	121	711	3.8	0.1	0.04	2.0	10.5%	236.8%	5.9%	121.3%	13%	-141.0	7	/EPS Gwth/
Centamin	CEY	94	1083	10.3	0.9	0.22	4.0	4.5%	86.0%	-9.4%	38.3%	-13%	-0.4	6	/EPS Gwth/Mom or Upgrade/
EnQuest	ENQ	16	311	1.4	1.3	0.08	1.3	0.0%	25.2%	16.1%	20.6%	-2%	-656.4	6	/Mom or Upgrade/
Ricardo	RCDO	574	357	14.4	0.3	0.13	6.7	1.9%	156.8%	18.5%	87.7%	4%	-62.8	6	/EPS Gwth/RoE or margin/
Fuller, Smith & Turner	FSTA	582	226	22.0	0.6	0.35	10.8	0.0%	57.1%	24.0%	40.5%	16%	-51.8	6	/RoE or margin/Debt to Ebitda/
Hochschild Mining	HOC	82	422	8.6	0.0	0.06	3.5	0.0%	509.4%	205.5%	357.4%	21%	-58.6	6	/EPS Gwth/RoE or margin/
Hydrogenone Capital Gwth	HGEN	76	98	8.1	0.1	0.09	42.5	0.0%	592.9%	14.8%	303.8%	42%	-	6	/EPS Gwth/Cash Conv/

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
Gaming Realms	GMR	29	84	12.6	0.2	0.41	11.3	0.0%	60.5%	36.8%	48.6%	9%	-0.6	8	na
Argentex	AGFX	122	138	11.8	0.2	0.42	3.2	1.0%	33.2%	30.5%	31.9%	-2%	-	7	/Mom or Upgrade/
H&T Group	HAT	435	191	7.2	0.2	0.16	4.8	3.4%	48.2%	22.6%	35.4%	-1%	-1.5	7	/Cash Conv/
Griffin Mining	GFM	82	158	5.0	0.2	0.05	4.4	0.0%	495.5%	-30.3%	232.6%	8%	-11.3	7	/EPS Gwth/
ZOO Digital	ZOO	116	113	14.2	0.2	0.14	12.5	0.0%	117.2%	50.3%	83.7%	-40%	-18.0	6	/EPS Gwth/Mom or Upgrade/
Microlise	SAAS	130	151	30.0	0.4	0.43	20.9	0.0%	245.3%	16.2%	130.8%	-22%	-13.3	6	/EPS Gwth/RoE or margin/
tinyBuild	TBLD	44	90	6.7	0.3	0.24	8.9	0.0%	39.7%	7.9%	23.8%	-16%	5.1	6	/RoE or margin/Mom or Upgrade/
Eagle Eye Solutions	EYE	563	165	40.6	0.3	0.18	26.4	0.0%	504.8%	24.0%	264.4%	-1%	-8.6	6	/EPS Gwth/RoE or margin/
Vertu Motors	VTU	63	217	5.7	0.7	0.33	5.4	3.4%	24.3%	8.3%	16.3%	4%	-737.4	6	/RoE or margin/Debt to Ebitda/
LBG Media	LBG	97	200	14.7	0.3	0.19	13.8	0.0%	154.4%	7.6%	81.0%	9%	23.1	6	/EPS Gwth/Cash Conv/
Serica Energy	SQZ	250	960	3.1	-	0.09	0.4	8.8%	38.7%	-11.2%	13.7%	19%	186.7	6	/EPS Gwth/3yr PEG<1/
Yu Group	YU	670	112	10.6	0.2	0.07	3.6	0.4%	88.6%	25.0%	56.8%	24%	-54.9	6	/EPS Gwth/Cash Conv/

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
Caterpillar	CAT	247.67	127638	13.7	0.9	0.4	12.4	1.9%	29.0%	2.3%	14%	-24527.0	8	/5yr EPS gwth/	Trucks/Construction/Farm Machinery
Tapestry	TPR	43.44	10069	10.3	0.8	0.9	8.5	2.6%	11.8%	9.3%	7%	-515.6	8	/Mid PE/	Apparel/Footwear Retail
Chubb	CB	191.26	79215	10.0	0.6	1.0	-	1.7%	19.4%	11.3%	2%	-	8	/Q +ve EPS/	Property/Casualty Insurance
Everest Re	RE	344.25	13520	6.8	0.2	0.6	-	1.9%	64.5%	28.9%	2%	-	8	/5yr EPS gwth/	Property/Casualty Insurance
VICI Properties	VICI	32.54	32678	12.9	0.4	0.3	24.7	4.7%	92.1%	6.6%	3%	-	8	/5yr EPS gwth/	Real Estate Investment Trusts

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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