Investors' Chronicle | Alpha

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AlphaScreens: the market according to GARP

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US large cap growth is still the best value

Growth at a reasonable price, or GARP, has proved a reliable strategy that has previously generated market-beating returns. America's big tech stocks have benefited from confidence US rate tightening could be ending soon and the buzz around Artificial Intelligence. Whether other growth stocks do well, too, or if value investing principles should be favoured is unclear, but GARP combines elements of both.

Comment by Alpha editor:

- Last time we ran our growth at a reasonable price (GARP) screen, it was noticeable how well **Meta Platforms (US:META)** did. A strong set of quarterly numbers and optimism around AI, had supported a turnaround in sentiment after its tough 2022, when the wider tech sell-off and a decidedly unenthusiastic response to its metaverse plans saw the shares punished. Upgrades in analysts' earnings expectations have followed (see our last EPS momentum screen), but there has been some retracement of share price gains in the last month, and now Meta is rated on approximately 19x next twelve months' earnings. Not cheap, but its average over the past eight years is almost 24x.
- Arguably, the most hyped stock of 2023 has been **Nvidia (US:NVDA)**, the leading manufacturer of the graphics processing units (GPUs) - chips powering the artificial intelligence boom. Nvidia doesn't quite make the top echelon of our reasonably priced growers, but it still passes seven tests.
- With a NTM PE of 35x it's surprising that Nvidia scores so well. However, the incredible rate of earnings growth forecast over the next three years reflects the company's leadership in a technology that many believe will be transformational. In a note of caution, one of the tests failed by Nvidia is that its trailing PE is too high. That's understandable given it's being valued on future earnings affected by a meteoric upgrade cycle, but meteors crash. When a narrative gets as powerful as AI then there is professional risk for analysts in being seen to be behind the curve and perhaps not enough scepticism exists. Of course, there is a very good chance that the optimists are right, but building a position steadily could be most sensible.

After all, there will likely be bumps in the road for the AI story and as one of our other tests shows, year-on-year earnings growth can vary from quarter to quarter which may offer the chance of better points to make larger acquisitions of Nvidia shares.

August 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
Coca-Cola HBC	CCH	2309	8504	13.3	0.5	0.5	8.9	2.9%	60.8%	10.0%	-3%	-1139.1	7	5yr EPS gwth/HY +ve EPS/

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
Intermediate Capital	ICP	1343	3903	10.3	0.3	0.4	27.8	5.8%	51.3%	21.4%	-4%	-	7	5yr EPS gwth/HY +ve EPS/

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
Centaur Media	CAU	39	58	9.9	0.5	0.31	7.7	3.0%	48.5%	5.1%	26.8%	-19%	-11.0	7	/RoE or margin/
Seplat Energy	SEPL	122	718	5.6	0.2	0.43	2.7	10.7%	116.2%	16.0%	66.1%	5%	-141.0	7	/EPS Gwth/
EnQuest	ENQ	17	317	1.3	1.1	0.12	1.3	0.0%	16.5%	34.9%	25.7%	12%	-656.4	7	/
Rathbones	RAT	1758	1115	12.6	0.4	0.44	0.1	4.8%	40.8%	28.5%	34.6%	-11%	-	6	/Mom or Upgrade/Cash Conv/
Centamin	CEY	90	1046	8.9	0.8	0.12	3.4	4.0%	126.3%	-19.2%	53.5%	-10%	-0.4	6	/EPS Gwth/Mom or Upgrade/
Fuller, Smith & Turner Class A	FSTA	556	214	21.2	0.6	0.36	10.4	2.6%	50.5%	20.0%	35.2%	3%	-51.8	6	/RoE or margin/Debt to EBITDA/
Marston's	MARS	33	217	4.8	0.2	0.19	11.0	0.0%	27.3%	27.0%	27.1%	3%	-240.0	6	/Cash Conv/Debt to EBITDA/
Hochschild Mining	HOC	94	482	9.3	0.0	0.38	3.8	0.0%	90.4%	842.7%	466.5%	29%	-58.6	6	/EPS Gwth/RoE or margin/s

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
YouGov	YOU	860	1007	19.3	0.5	0.49	12.5	0.8%	65.4%	13.4%	39.4%	-12%	-53.1	8	na
Jet2JET2	1049	2252	6.4	0.5	0.32	2.2	1.0%	25.9%	6.9%	16.4%	-13%	368.2	8	na	
Argentex	AGFX	111	125	10.2	0.2	0.38	2.4	1.1%	33.8%	29.7%	31.7%	-2%	-	8	na
Ashtead Technology	AT	400	320	14.3	0.6	0.57	12.5	0.3%	42.3%	10.0%	26.1%	7%	-12.8	8	na
Gaming Realms	GMR	35	103	14.5	0.3	0.45	14.1	0.0%	62.5%	33.9%	48.2%	16%	-0.6	8	na
H&T Group	HAT	402	177	6.4	0.2	0.20	5.6	4.1%	43.1%	26.4%	34.7%	-2%	-1.5	7	/Cash Conv/
Griffin Mining	GFM	84	163	7.6	0.3	0.12	4.6	0.0%	207.4%	-43.8%	81.8%	-2%	-11.3	7	/EPS Gwth/
Mind Gym	MIND	61	61	12.2	-	0.32	11.1	0.0%	66.6%	14.2%	40.4%	3%	-5.0	7	/3yr PEG<1/
Kistos Holdings	KIST	249	206	2.6	0.0	0.02	0.3	0.0%	232.6%	11.8%	122.2%	7%	24.7	7	/EPS Gwth/
Serica Energy	SQZ	247	948	3.2	2.6	0.28	0.4	8.9%	12.0%	17.9%	15.0%	16%	186.7	7	/3yr PEG<1/
Water Intelligence	WATR	416	72	15.2	0.5	0.39	8.4	0.0%	67.9%	12.0%	39.9%	-6%	5.0	6	/RoE or margin/Mom or Upgrade/
Eagle Eye Solutions	EYE	545	159	35.8	0.3	0.16	25.5	0.0%	561.3%	18.3%	289.8%	-2%	-8.6	6	/EPS Gwth/RoE or margin/
Atalaya Mining	ATYM	325	455	6.9	0.2	0.31	7.7	2.1%	59.4%	62.5%	60.9%	1%	-16.9	6	/EPS Gwth/RoE or margin/
Oxford Metrics	OMG	97	127	22.8	-	0.52	15.1	2.6%	41.7%	16.4%	29.1%	6%	56.0	6	/3yr PEG<1/Cash Conv/
Kitwave	KITW	301	211	10.6	0.7	0.32	8.5	3.5%	40.1%	1.3%	20.7%	12%	-78.3	6	/Cash Conv/Debt to EBITDA/
Yu Group	YU	925	155	11.2	0.2	0.07	5.2	0.3%	118.7%	39.4%	79.1%	101%	-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
Booking Holdings	BKNG	3130.6	111738	19.6	0.6	0.9	18.2	0.0%	43.6%	17.0%	24%	3952.0	9	na	Other Consumer Services
United Rentals	URI	477.4	32599	11.5	0.8	0.7	7.2	0.6%	23.1%	6.2%	38%	-2339.0	8	/Mid PE/	Finance/Rental/Leasing
Caterpillar	CAT	282.3	144029	13.7	0.7	0.3	12.1	1.7%	43.9%	4.8%	35%	-24527.0	8	/5yr EPS gwth/	Trucks/Constr/Farm Mchry
Meta Platforms Class A	META	295.1	655884	18.8	0.5	1.0	15.7	0.0%	56.0%	25.5%	12%	14006.0	8	/Q +ve EPS/	Internet Software/Services
Chubb	CB	201.8	82870	10.1	0.6	0.8	-	1.7%	21.7%	11.2%	6%	-	8	/Mid PE/	Property/Casualty Insurance
T-Mobile US	TMUS	137.4	161633	14.8	0.1	0.2	8.5	0.0%	259.3%	37.7%	2%	-20235.0	8	/5yr EPS gwth/	Wireless Telecomms
Lamb Weston	LW	97.6	14230	17.9	1.4	0.9	16.4	1.1%	13.2%	11.9%	-11%	-1055.4	8	/Fwd PEG < 1/	Food: Specialty/Candy

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 market.

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. **Compulsory test**.
- 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).

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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