

AlphaScreens: the quest for quality

17 January 2022

Quality sin stocks

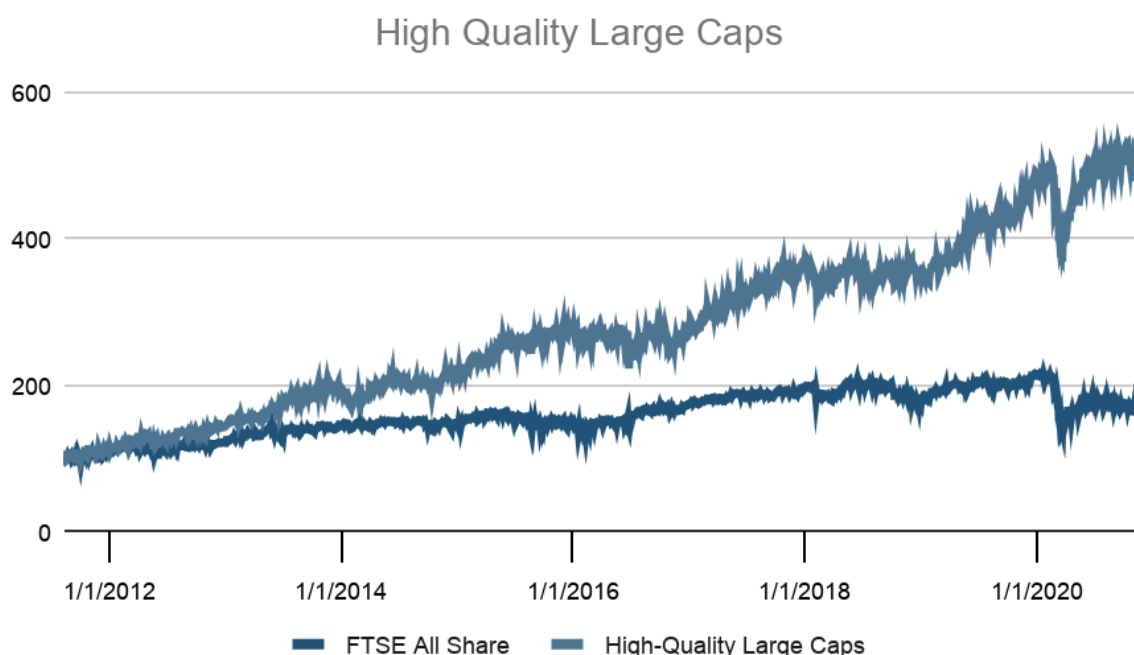
The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on capital and sustaining it while reinvesting profits. This screen looks for shares that display these quality characteristics and can potentially deliver significant compounded returns over time

Comment by Alpha editor:

- Our first Alpha quality screen of 2022 is topped by tobacco giant Imperial Brands (IMB), which out of all the FTSE All Share companies that doesn't fail a test has the best combination of three-month share price momentum and operating margin. The defensive characteristics of this so-called sin stock may appeal to some investors who are worried about head winds to a smooth economic restart. The dividend is also attractive especially in times of rocketing inflation, as although nominal bond yields are set to rise, in real terms safer government debt doesn't offer a great income.
- Along with tobacco, high quality alcoholic beverages are present at the quality shares party, with Diageo (DGE) passing all but one test (for margin growth). Britvic (BVIC) might be making the mixers, but if one were to extend the sin stock theme to this business it would probably be for sugar in drinks. It also fails the margin growth test but otherwise the showing against our screen rules reinforces the shares' quality credentials.
- One recurring theme in our quality screens is for companies that produce tools and solutions for their customers. Data business Experian (EXPN) is the only other FTSE All Share company scoring 9/9 this month, and it falls into the solutions category. Other high-ranking companies that do too include science and technology equipment provider Oxford Instruments (OXIG) and Hikma Pharmaceuticals (HIK)
- Our Aim screen is still topped by software as a service (SaaS) solutions provider iEnergizer (IBPO). Another company with a technological focus that achieves full marks is Eckoh (ECK), a small business that provides payment and customer interaction solutions for clients.

The dream company

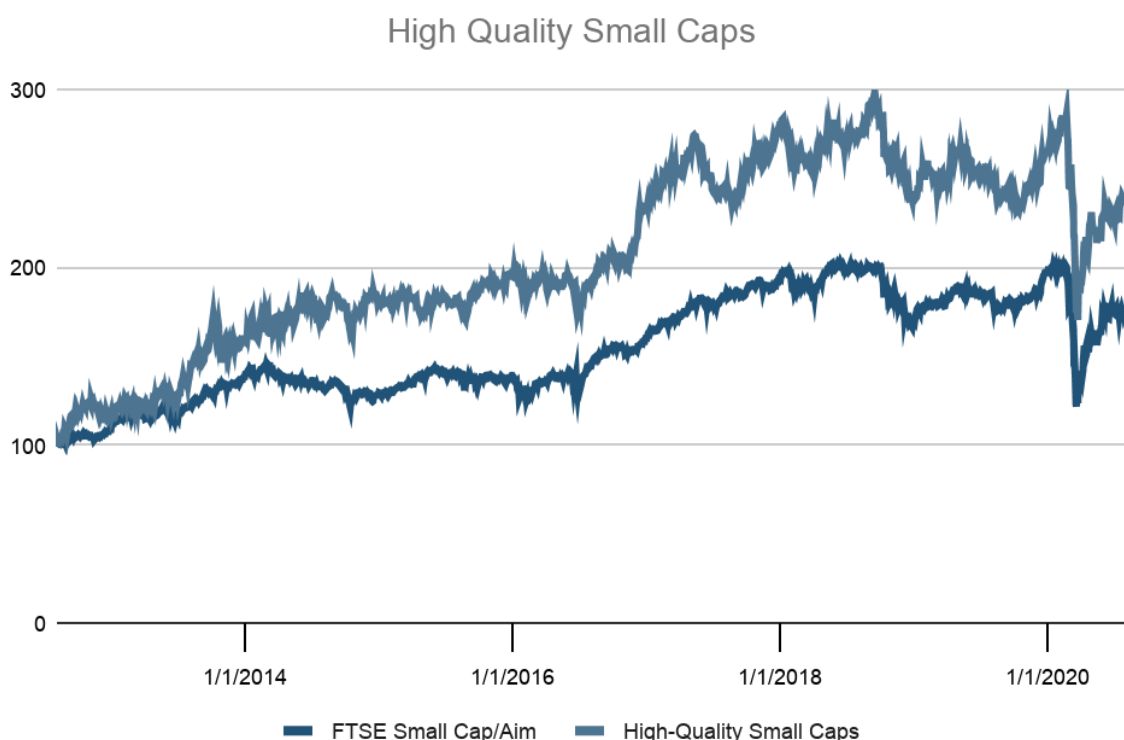
The holy grail for buy-and-hold investors is to find a business that is capable of generating high returns on its capital and is able to reinvest all its profits for decades to come, while maintaining those returns. The compounding effect of such an investment is what every long-term investor's dreams should be made of. A company making a consistent 15 per cent post-tax return on its equity and reinvesting all its profits would experience a near-30-fold (28.6 to be precise) growth in its equity base over 25 years, and after 50 years it would be a mind-boggling 1,084 times bigger than when it started. For a patient investor convinced that they have found such a situation, valuation should not act as a major impediment to a purchase.



Source: Refinitiv, Investors' Chronicle

Unfortunately, this kind of dream company is extremely rare and stock screens are too crude to provide the depth of analysis needed to provide confidence that a business may be the real deal. In particular, it is inevitable that some of the shares highlighted by our Alpha Quality screen will be cyclical companies that are enjoying a good run rather than companies that are well placed to sustain high returns through many business cycles to come. What our screen does do, however, is attempt to find pointers for companies that may have the potential to go some way to filling the dream brief. What's more, buying shares

in companies that look attractive based on quality metrics can often prove a profitable strategy, even if many of the shares picked fall short of the buy-and-hold ideal.



Source: Refinitiv, Investors' Chronicle

Alpha Quality screening criteria

Our Alpha Quality screen uses two key measures of quality: operating margins and return on equity. We are mindful that debt can flatter a company's return on equity, so we aim to reduce this risk from the screening results by introducing interest cover tests, to eliminate companies that are aggressively gearing up their balance sheet. The screen uses two key measures of quality, which are operating margins and return on equity (RoE).

The advantage of using RoE to measure the quality of a company is that it focuses on the returns that are ultimately of most significance to shareholders: after-tax earnings. However, RoE can be boosted by a company if it increases the amount of debt it carries. That means a high and rising RoE can sometimes simply reflect a reduction in the quality of the company's balance sheet and little improvement, or even a deterioration, in the quality of its operations. The screen attempts to counter this with its interest cover test, which should help it avoid companies with very aggressively 'geared' balance sheets. Focusing on

operating margins also provides an assessment of quality at the operating level – i.e. before the impact of debt.

- An operating margin higher than the median average (mid-ranking) stock in each of the past three years (i.e. quality that shows some signs of persistence).
- A return on equity (RoE) higher than the median average (mid-ranking) stock in each of the past three years (i.e. again, quality that shows some signs of persistence).
- RoE higher than it was two years ago (i.e. quality is improving as well as persistent).
- Operating margin higher than it was two years ago (i.e. quality is improving as well as persistent).
- A dividend-and-debt adjusted price/earnings growth (PEG) ratio below the top fifth of stocks screened (ie stocks must not be too egregiously expensive for the growth on offer).
- A price/earnings (PE) ratio above the bottom 10 per cent of stocks screened and below the top 10 per cent (i.e. not a suspiciously cheap or dangerously expensive valuation).
- Interest cover of more than five (i.e. high RoE is not overly dependent on the use of debt).
- Forecast earnings growth for each of the next two financial years.
- Positive forecast free cash flow.

The Alpha Quality screen is conducted separately on constituents of the FTSE All-Share, FTSE All-Small and FTSE Aim All-Share indices, with the results from each screen reported in separate tables.

Not many stocks pass such a stringent list of criteria. The ones that pass all the tests are listed at the top of the table, followed by those failing one test, then those failing two tests as detailed in the 'Tests passed' column. All stocks must pass the test for three-year, higher-than-average RoE and margin 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 operating margin and three-month share price momentum.

Large-cap quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Imperial Brands	IMB	£16,179m	1,709p	7	8.1%	0.6%	5.7%	9.5%	-9,521m	9	na
Experian	EXPN	£28,382m	3,077p	31	1.2%	25.0%	13.8%	-4.4%	-1,606m	9	na
BHP	BHP	£50,236m	2,379p	11	9.2%	8.4%	-28.2%	19.4%	-835m	8	/Fwd EPS grth/
Dunelm	DNLM	£2,826m	1,394p	18	7.2%	21.8%	3.4%	7.4%	-107m	8	/RoE grth/
Diageo	DGE	£86,405m	3,718p	26	2.0%	16.1%	12.1%	2.2%	-4,272m	8	/Marg grth/
Britvic	BVIC	£2,492m	932p	17	2.6%	23.2%	9.5%	2.8%	-494m	8	/Marg grth/
Oxford Instruments	OXIG	£1,303m	2,260p	26	0.8%	8.2%	2.2%	-4.8%	-46m	8	/PEG/
Games Workshop	GAW	£2,808m	8,550p	22	2.6%	4.6%	3.9%	-16.4%	41m	8	/PEG/
Hikma Pharmaceuticals	HIK	£4,760m	2,056p	13	1.8%	14.6%	14.1%	-13.4%	-495m	8	/Marg grth/
Spirent Communications	SPT	£1,433m	234p	19	1.9%	13.0%	5.4%	-18.6%	63m	8	/Marg grth/
Auto Trader	AUTO	£6,515m	688p	25	1.1%	89.7%	10.9%	15.4%	21m	7	/RoE grth/Marg grth/
Sage	SGE	£8,136m	798p	30	2.2%	12.2%	13.2%	11.2%	-827m	7	/PEG/Marg grth/
Berkeley	BKG	£4,995m	4,457p	12	0.2%	13.5%	1.1%	3.7%	-254m	7	/RoE grth/Marg grth/
Rightmove	RMV	£5,869m	693p	29	1.1%	69.2%	10.6%	0.2%	74m	7	/RoE grth/Marg grth/
Victrex	VCT	£1,999m	2,298p	23	2.6%	16.3%	9.7%	-2.1%	56m	7	/RoE grth/Marg grth/
Coats	COA	£973m	67p	13	2.1%	169.0%	14.6%	0.9%	-210m	7	/RoE grth/Marg grth/
A.G. BARR.	BAG	£571m	510p	17	0.4%	23.6%	8.4%	-0.4%	4m	7	/RoE grth/Marg grth/
Smith & Nephew	SN	£11,090m	1,261p	18	2.2%	30.4%	14.2%	-1.1%	54m	7	/RoE grth/Marg grth/
Electrocomponents	ECM	£5,218m	1,108p	22	2.0%	47.6%	12.1%	1.0%	-433m	7	/RoE grth/Marg grth/
Croda International	CRDA	£11,753m	8,424p	32	1.1%	35.9%	10.4%	-4.1%	-239m	7	/RoE grth/Marg grth/
PayPoint	PAY	£472m	686p	13	4.9%	134.0%	6.3%	-4.2%	-182m	7	/RoE grth/Marg grth/
Persimmon	PSN	£8,137m	2,549p	10	9.2%	13.6%	3.7%	-4.9%	359m	7	/RoE grth/Marg grth/
IMI	IMI	£4,278m	1,641p	16	1.4%	13.7%	12.7%	-2.6%	-376m	7	/RoE grth/Marg grth/
Next	NXT	£9,875m	7,428p	13	0.0%	131.6%	7.0%	-4.9%	-578m	7	/RoE grth/Marg grth/
Halma	HLMA	£10,087m	2,657p	39	0.7%	8.0%	10.7%	-7.8%	-114m	7	/PEG/RoE grth/
Ferrexpo	FXPO	£1,633m	277p	5	25.8%	85.5%	-55.6%	-12.5%	-19m	7	/Marg grth/Fwd EPS grth/
Spirax-Sarco Engineering	SPX	£9,886m	13,430p	39	0.9%	28.4%	4.5%	-10.1%	18m	7	/RoE grth/Marg grth/
Kainos	KNOS	£1,918m	1,549p	38	1.4%	4.0%	8.4%	-20.2%	8m	7	/PEG/PE/

Source: FactSet, 17 January 2022

Small-cap quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Up Global Sourcing	UPGS	£165m	185p	13	2.7%	31.6%	6.8%	16.7%	-39m	8	/RoE grth/
Norcros	NXR	£261m	322p	9	3.5%	13.1%	4.2%	-1.5%	-76m	8	/RoE grth/
A.G. BARR	BAG	£571m	510p	17	0.4%	23.6%	8.4%	-0.4%	4m	7	/RoE grth/Marg grth/
PayPoint	PAY	£472m	686p	13	4.9%	134.0%	6.3%	-4.2%	-182m	7	/RoE grth/Marg grth/
Goodwin	GDWN	£250m	3,250p	-	3.1%	-	-	-11.0%	-30m	7	/PEG/Fwd EPS grth/
RM	RM	£163m	194p	9	2.4%	15.9%	34.8%	-11.2%	-59m	7	/RoE grth/Marg grth/

Source: FactSet, 17 January 2022

Aim quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
iEnergizer Ltd	IBPO	£624m	328p	11	5.0%	31.6%	22.8%	17.1%	11m	9	na
Cerillion	CER	£267m	905p	28	0.8%	18.3%	19.9%	11.0%	3m	9	na
Pan African Resources	PAF	£420m	19p	6	4.5%	18.8%	4.5%	9.2%	-51m	9	na
Keystone Law	KEYS	£263m	840p	39	1.8%	31.5%	6.2%	3.1%	-8m	9	na
Alumasc	ALU	£80m	222p	9	4.3%	1.3%	6.7%	-2.6%	-19m	9	na
Eckoh	ECK	£147m	51p	26	1.2%	37.3%	39.6%	-7.3%	-7m	9	na
CareTech	CTH	£624m	551p	11	2.6%	3.6%	10.0%	-11.8%	-67m	9	na
Alpha Fin. Mkts Consulting	AFM	£524m	443p	23	1.7%	23.0%	11.5%	28.0%	4m	8	/RoE grth/
Craneware	CRW	£847m	2,385p	38	1.2%	21.1%	8.6%	1.9%	135m	8	/RoE grth/
SDI	SDI	£194m	194p	29	0.0%	20.6%	-10.4%	2.9%	-12m	8	/Fwd EPS grth/
Springfield Properties	SPR	£176m	149p	8	3.9%	13.5%	20.7%	7.6%	-71m	8	/RoE grth/
Sureserve	SUR	£162m	99p	12	1.0%	66.4%	20.8%	11.9%	-38m	8	/Marg grth/
Mattioli Woods	MTW	£413m	815p	15	2.6%	20.0%	17.7%	1.9%	-3m	8	/RoE grth/
MTI Wireless Edge	MWE	£65m	73p	22	2.0%	15.5%	4.3%	2.8%	0m	8	/Marg grth/
Fonix Mobile	FNX	£156m	156p	20	3.4%	8.6%	9.2%	-1.0%	-21m	8	/FCF/
Kape Technologies	KAPE	£1,427m	408p	14	0.0%	69.2%	59.4%	-0.7%	-22m	8	/Marg grth/
Knights Group	KGH	£352m	420p	17	0.3%	20.2%	15.9%	-1.2%	-36m	8	/RoE grth/
Renew	RNWH	£631m	800p	15	2.0%	7.8%	2.8%	4.6%	-230m	8	/RoE grth/
Steppe Cement	STCM	£94m	43p	8	8.1%	43.2%	4.5%	-4.4%	-3m	8	/Marg grth/
Water Intelligence	WATR	£189m	1,090p	46	0.0%	49.4%	18.7%	-2.7%	-3m	8	/Marg grth/
Caledonia Mining Corp.	CMCL	£109m	920p	4	4.3%	5.2%	47.7%	-8.0%	7m	8	/Marg grth/
Gateley	GTLY	£264m	221p	15	4.8%	6.5%	11.4%	-7.1%	-13m	8	/RoE grth/
RWS	RWS	£2,222m	571p	20	1.8%	16.1%	10.5%	-8.1%	-98m	8	/RoE grth/
Gamma Communications	GAMA	£1,522m	1,580p	23	0.8%	21.2%	11.9%	-13.4%	-21m	8	/Marg grth/
Tristel	TSTL	£191m	405p	37	1.6%	20.7%	20.3%	-21.1%	4m	8	/RoE grth/
CVS	CVSG	£1,426m	2,010p	24	0.3%	8.2%	6.6%	-16.4%	-65m	8	/PEG/
Lok'nStore	LOK	£319m	1,065p	31	1.4%	193.7%	11.0%	38.3%	2m	7	/RoE grth/FCF/
Somero Enterprises, Inc.	SOM	£328m	585p	13	5.0%	79.8%	8.0%	18.2%	17m	7	/RoE grth/Marg grth/
Dewhurst Class A	DWHA	£92m	725p	-	1.9%	-	-	29.5%	12m	7	/PEG/Fwd EPS grth/
Clinigen	CLIN	£1,207m	905p	16	0.8%	-2.1%	10.7%	45.1%	-95m	7	/PEG/Fwd EPS grth/
YouGov	YOU	£1,601m	1,440p	51	0.4%	24.7%	25.5%	16.1%	-32m	7	/PEG/RoE grth/
Watkin Jones	WJG	£675m	264p	14	3.8%	5.6%	10.5%	13.6%	14m	7	/RoE grth/Marg grth/
Nichols	NICL	£526m	1,430p	26	1.3%	86.7%	16.4%	19.9%	26m	7	/RoE grth/Marg grth/
James Halstead	JHD	£1,242m	298p	30	2.6%	2.6%	0.7%	9.2%	14m	7	/PEG/RoE grth/
Franchise Brands	FRAN	£155m	162p	25	0.9%	27.6%	19.3%	16.6%	-1m	7	/RoE grth/Marg grth/
Michelmersh Brick	MBH	£125m	130p	15	2.8%	69.7%	3.6%	8.3%	-2m	7	/RoE grth/Marg grth/
Character	CCT	£133m	620p	15	2.4%	2.1%	0.4%	19.8%	-5m	7	/PEG/Marg grth/
James Latham	LTHM	£260m	1,305p	-	1.7%	-	-	10.1%	-7m	7	/PEG/Fwd EPS grth/
Judges Scientific	JDG	£536m	8,480p	34	0.7%	33.5%	6.0%	9.0%	-7m	7	/RoE grth/Marg grth/
Solid State	SOLI	£106m	1,235p	21	1.4%	9.2%	-1.3%	14.4%	-9m	7	/PEG/Fwd EPS grth/
Time Finance	TIME	£24m	26p	7	0.0%	40.5%	73.1%	9.4%	-	7	/RoE grth/Marg grth/
Focusrite	TUNE	£817m	1,393p	28	0.4%	-15.5%	2.9%	1.6%	-8m	7	/PEG/Fwd EPS grth/
Spectra Systems Corp.	SPSY	£70m	155p	15	4.3%	16.6%	2.5%	-0.3%	8m	7	/Marg grth/Int Cov/
K3 Capital	K3C	£247m	338p	16	2.7%	8.4%	22.6%	1.5%	-	7	/PEG/RoE grth/
Jubilee Metals	JLP	£392m	16p	6	0.0%	-18.4%	73.7%	-1.1%	-20m	7	/PEG/Fwd EPS grth/
Oxford Metrics	OMG	£146m	115p	34	1.7%	39.1%	18.7%	3.6%	10m	7	/RoE grth/Marg grth/
Alliance Pharma	APH	£554m	103p	16	1.6%	8.9%	12.5%	-0.2%	-1m	7	/RoE grth/Marg grth/
Team17	TM17	£989m	740p	33	-	7.8%	15.4%	-2.6%	44m	7	/PEG/Marg grth/
Finsbury Food	FIF	£127m	98p	9	2.5%	32.6%	-4.4%	4.8%	-57m	7	/Marg grth/Fwd EPS grth/
Dewhurst	DWHT	£92m	1,740p	-	0.8%	-	-	-0.6%	12m	7	/PEG/Fwd EPS grth/
M.P. Evans	MPE	£450m	823p	13	3.3%	214.9%	-26.3%	-4.5%	-32m	7	/Marg grth/Fwd EPS grth/
Aferian plc	AFRN	£135m	159p	14	1.8%	43.2%	9.2%	1.3%	-13m	7	/RoE grth/Marg grth/
Next Fifteen Comm.	NFC	£1,086m	1,170p	20	0.9%	31.7%	7.1%	-0.4%	-85m	7	/RoE grth/PE/
Sylvania Platinum	SLP	£274m	100p	4	4.0%	-12.0%	14.6%	-7.0%	67m	7	/PEG/Fwd EPS grth/
Central Asia Metals	CAML	£400m	227p	6	7.0%	94.6%	2.6%	-7.0%	-14m	7	/RoE grth/Marg grth/
Epwin	EPWN	£157m	109p	12	2.5%	81.1%	26.9%	-0.5%	-66m	7	/RoE grth/Marg grth/
Cake Box	CBOX	£138m	345p	22	1.8%	48.5%	12.9%	-6.8%	0m	7	/RoE grth/Marg grth/
Mission	TMG	£63m	70p	8	1.2%	500.0%	43.3%	0.7%	-43m	7	/RoE grth/Marg grth/
SigmaRoc	SRC	£625m	98p	15	0.0%	20.4%	32.9%	-3.0%	-23m	7	/RoE grth/Marg grth/
Begbies Traynor	BEG	£200m	131p	14	2.4%	31.7%	9.9%	-5.8%	-31m	7	/RoE grth/PE/

Continued...

Aim quality selection (passing at least 7 of 9 tests) continued

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-) in £	Tests passed (out of 9)	Test failed
Advanced Medical Solutions	AMS	£648m	300p	28	0.6%	70.6%	14.5%	-9.1%	39m	7	/RoE grth/Marg grth/
EMIS	EMIS	£784m	1,238p	22	2.7%	4.9%	6.4%	-10.0%	-10m	7	/PEG/Marg grth/
Breedon	BREE	£1,507m	89p	14	0.6%	76.6%	25.0%	-7.3%	-283m	7	/RoE grth/Marg grth/
ASOS	ASC	£2,337m	2,338p	24	0.0%	-32.4%	35.5%	-5.4%	-335m	7	/PEG/Fwd EPS grth/
Keywords Studios	KWS	£2,026m	2,656p	34	0.0%	38.7%	6.3%	-13.1%	11m	7	/RoE grth/Marg grth/
GB Group	GBG	£1,683m	670p	31	1.0%	-19.7%	9.1%	-23.5%	-69m	7	/PEG/Fwd EPS grth/
dotDigital	DOTD	£516m	173p	40	0.5%	2.3%	9.1%	-31.3%	22m	7	/PEG/RoE grth/
Learning Technologies	LTG	£1,221m	155p	20	0.5%	14.5%	59.9%	-23.4%	6m	7	/PEG/Marg grth/
Netcall	NET	£103m	69p	39	0.5%	150.0%	18.7%	-16.9%	-4m	7	/Marg grth/Int Cov/
ECO Animal Health	EAH	£127m	188p	27	0.5%	-51.7%	24.6%	-36.4%	1m	7	/PEG/Fwd EPS grth/
Mind Gym	MIND	£150m	150p	70	0.0%	60.0%	435.7%	-21.1%	2m	7	/RoE grth/Marg grth/
Vollex	VLX	£471m	297p	14	1.1%	-11.2%	13.0%	-32.3%	-86m	7	/PEG/Fwd EPS grth/

Source: FactSet, 17 January 2022

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