Investors' Chronicle | Alpha

**Alpha Editor:** James Norrington
**Alpha Production Editor:** Sameera Hai Baig

# AlphaScreens: the quest for quality

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## Opportunity to top up on quality Alphabet

*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:**

The Nasdaq's so-called "magnificent seven" tech superstars – are never really cheap and certainly a current year forward PE (share price to predicted year-end earnings per share) of 21 doesn't make **Alphabet (US:GOOGL)** a bargain. There are reasons to consider topping up on one of the quality behemoths of the last two decades, however.

In the immediate term, Kyle Rodda, Senior Market Analyst at Capital.com counts a recovery in Google ad revenues as reason to be bullish. Citing Q3 2022's historic drop in sales, this YoY comparator is likely to give Q3 2023 a nice gloss, especially as top-line recovery is projected to "underpin a 36.6 per cent rebound in earnings per share to $1.44", in Rodda's view.

Artificial Intelligence is both an opportunity and a threat: **Microsoft's (US:MSFT)** integration of ChatGPT into its Bing search offering is a very serious threat to Google's dominance. That said, Alphabet is hardly standing still on AI, with innovations such as Duet AI for Google Cloud, having potential to help it disrupt tech rivals in important business areas where they currently lead.

Given the innovation race, it's hardly surprising that Alphabet fails our test to have more cash than two years ago, but on the cusp of the AI era, the company's track record on our core return on invested capital (ROIC) metric is reassuring. Furthermore, should the recent turmoil in the US Treasury market see real yields peak, then investors could start to become confident future changes in the market discount rate for shares would be more likely to work in their favour.

Our other quality screens see the likes of **YouGov (YOU)** and **Cerillion (CER)**, which issued a positive full-year trading update last week, riding high on Aim. On the UK main market, **RELX (REL)**, **Halma (HLMA)** and **Experian (EXPN)** maintain their consistency.

## UK large-cap quality shares (out of 10 tests)

| Name | Ticker | Share price (p) | Mkt cap (£mn) | Enterprise value (£mn) | Fwd 12-mth PE | Cur. EV to forec'st Ebitda | FCF yield | DY T12 | Forec'st EPS gwth rate cur. yr | Forec't EPS gwth rate next yr | 3-mth share price mom. | Return on inv. capital fy (%) | Cash return on capital fy (%) | EBIT margin t12 | Net debt fy (£mn) | Net debt/ Ebitda fy |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| RELX | REL | 2832 | 53501 | 60758 | 23.1 | 17.4 | 4.4% | 2.0% | 10.8% | 10.5% | 9.8% | 17% | 26% | 28% | 6396 | 2.0 |
| Halma | HLMA | 1811 | 6873 | 7460 | 21.6 | 15.7 | 3.1% | 1.1% | 5.1% | 8.1% | -19.2% | 11% | 12% | 17% | 597 | 1.4 |
| Experian | EXPN | 2642 | 24301 | 27507 | 21.2 | 13.7 | 5.6% | 1.7% | 9.8% | 10.0% | -11.9% | 10% | 23% | 24% | 3146 | 1.7 |
| BAE Systems | BA | 1062 | 32274 | 36058 | 15.9 | 10.9 | 6.3% | 2.6% | 12.8% | 8.1% | 13.6% | 10% | 17% | 10% | 3499 | 1.2 |
| Sage | SGE | 951 | 9766 | 10486 | 27.0 | 20.4 | 2.8% | 2.0% | 23.1% | 11.8% | 1.1% | 12% | 13% | 18% | 733 | 1.7 |
| Coca-Cola HBC | CCH | 2119 | 7805 | 9287 | 11.9 | 6.9 | 7.2% | 3.2% | 63.9% | 9.2% | -10.4% | 7% | 19% | 10% | 1485 | 1.3 |

Source: FactSet and Investors' Chronicle

## UK large-cap tests failed

| Name | Ticker | Tests passed | Tests failed |
|---|---|---|---|
| RELX | REL | 8 | /past EBIT marg grth/ Net debt to Ebitda/ |
| Halma | HLMA | 8 | /ROIC > 2yrs ago/Net debt down/ |
| Experian | EXPN | 7 | /ROIC > 2yrs ago/Net debt down/Net debt to Ebitda/ |
| BAE Systems | BA | 7 | /ROIC > 2yrs ago/EBIT margin > median/past EBIT marg grth/ |
| Sage | SGE | 6 | /ROIC > 2yrs ago/past EBIT marg grth/ Net debt down/Net debt to Ebitda/ |
| Coca-Cola HBC | CCH | 6 | /ROIC > 2yrs ago/EBIT margin > median/past EBIT marg grth/ Net debt down/ |

Source: FactSet and Investors' Chronicle

## UK mid-cap quality shares (out of 10 tests)

| Name | Ticker | Share price (p) | Mkt cap (£mn) | Enterprise value (£mn) | Fwd 12-mth PE | Cur. EV to forec't Ebitda | FCF yield | DY T12 | Forec't EPS gwth rate cur. yr | Forec't EPS gwth rate next yr | 3-mth share price mom. | Return on inv. capital fy (%) | Cash return on capital fy (%) | EBIT margin t12 | Net debt fy (£mn) | Net debt/ Ebitda fy |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Kainos | KNOS | 1106 | 1384 | 1283 | 22.3 | 16.3 | 4.4% | 2.2% | 7.7% | 15.3% | -16.8% | 35% | 53% | 13% | -107 | -2.0 |
| Games Workshop | GAW | 9795 | 3224 | 3182 | 22.0 | 14.2 | 5.6% | 4.8% | 6.4% | 6.0% | -13.1% | 49% | 71% | 37% | -40 | -0.2 |
| Auto Trader | AUTO | 597 | 5462 | 5691 | 19.9 | 16.0 | 4.7% | 1.4% | 2.6% | 13.8% | -9.0% | 44% | 50% | 55% | 52 | 0.2 |
| IMI | IMI | 1465 | 3822 | 4570 | 11.7 | 9.0 | 5.1% | 1.8% | 10.4% | 9.6% | -9.8% | 16% | 18% | 17% | 810 | 1.8 |
| Moneysupermarket.com | MONY | 261 | 1400 | 1454 | 15.4 | 11.2 | 7.1% | 4.5% | 10.5% | 8.8% | -5.8% | 25% | 38% | 25% | 56 | 0.5 |
| Rotork | ROR | 296 | 2548 | 2456 | 18.7 | 13.6 | 2.0% | 2.3% | 15.8% | 9.5% | -5.1% | 16% | 10% | 22% | -106 | -0.7 |
| B&M European Value Retail | BME | 538 | 5397 | 7418 | 13.5 | 8.6 | 12.1% | 2.7% | 5.1% | 8.4% | -4.6% | 13% | 27% | 11% | 2018 | 2.6 |
| Diploma | DPLM | 2828 | 3790 | 3783 | 21.4 | 14.7 | 3.1% | 2.0% | 14.4% | 7.2% | -9.4% | 10% | 14% | 15% | 398 | 1.9 |

Source: FactSet, Investors' Chronicle

## UK mid-cap tests failed

| Name | Ticker | Tests passed | Tests failed |
|---|---|---|---|
| Kainos | KNOS | 9 | /ROIC > 2yrs ago/ |
| Games Workshop | GAW | 8 | /ROIC > 2yrs ago/cash conv/ |
| Auto Trader | AUTO | 8 | /past EBIT marg grth/ Net debt down/ |
| IMI | IMI | 8 | /Net debt down/Net debt to Ebitda/ |
| Moneysupermarket.com | MONY | 7 | /ROIC > 2yrs ago/past EBIT marg grth/ Net debt down/ |
| Rotork | ROR | 7 | /past EBIT marg grth/ cash conv/Net debt down/ |
| B&M European Value Retail | BME | 6 | /ROIC > 2yrs ago/past EBIT marg grth/ Net debt down/Net debt to Ebitda/ |
| Diploma | DPLM | 6 | /ROIC > 2yrs ago/past EBIT marg grth/ Net debt down/Net debt to Ebitda/ |

Source: FactSet and Investors' Chronicle

Continued below

## UK small-cap quality shares (out of 12 tests)

| Name | Ticker | Share price (p) | Mkt cap (£mn) | Enterprise value (£mn) | Fwd 12-mth PE | Cur EV to forec't Ebitda | FCF yield | EV/ sales | DY T12 | Forec't EPS gwth rate cur.yr | Forec't EPS gwth rate next yr | 3-mth share price mom. | Return on inv. capital fy (%) | Cash return on capital fy (%) | EBIT margin t12 | Net debt fy (£mn) | Net debt/ Ebitda fy |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| A.G.BARR | BAG | 503 | 564 | 523 | 14.6 | 9.0 | 3.8% | 1.65 | 2.6% | 8.5% | 10.1% | 3.1% | 13% | 14% | 12% | -48 | -0.9 |

Source: FactSet and Investors' Chronicle

## Small-cap tests failed

| Name | Ticker | Tests passed | Tests failed |
|---|---|---|---|
| A.G. BARR | BAG | 11 | /past EBIT marg grth/ |

Source: FactSet and Investors' Chronicle

## UK Aim-listed quality shares (out of 12 tests)

| Name | Ticker | Share price (p) | Mkt cap (£mn) | Enterprise value (£mn) | Fwd 12-mth PE | Cur. EV to forec't Ebitda | FCF yield | EV/ sales | DY T12 | Forec't EPS gwth rate cur.yr | Forec't EPS gwth rate next yr | 3-mth share price mom. | Return on inv. capital fy (%) | Cash return on capital fy (%) | EBIT margin t12 | Net debt fy (£mn) | Net debt/ Ebitda fy |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| YouGov | YOU | 876 | 1026 | 886 | 18.7 | 8.9 | 5.9% | 3.4 | 1.0% | 11.5% | 27.9% | -15.4% | 20% | 35% | 17% | -96 | -1.4 |
| Franchise Brands | FRAN | 155 | 300 | 325 | 14.8 | 11.1 | 3.8% | 3.5 | 1.4% | 8.7% | 18.4% | 1.0% | 9% | 10% | 9% | -8 | -0.6 |
| Cerillion | CER | 1185 | 350 | 330 | 25.8 | 19.0 | 3.3% | 10.1 | 0.8% | 22.6% | 5.6% | -6.7% | 35% | 46% | 41% | -16 | -1.0 |
| Eleco | ELCO | 83 | 69 | 61 | 19.7 | 10.6 | 7.8% | 2.3 | 0.9% | 2.9% | 24.3% | 7.8% | 9% | 21% | 9% | -10 | -2.1 |
| Volex | VLX | 280 | 508 | 556 | 8.4 | 6.4 | 7.4% | 0.9 | 1.4% | 33.7% | 19.7% | -0.7% | 12% | 18% | 7% | 84 | 1.3 |

Source: FactSet and Investors' Chronicle

## Aim tests failed

| Name | Ticker | Tests passed | Tests failed |
|---|---|---|---|
| YouGov | YOU | 12 | / |
| Franchise Brands | FRAN | 12 | / |
| Cerillion | CER | 11 | /past EBIT marg grth/ |
| Eleco | ELCO | 10 | /ROIC > 2yrs ago/past EBIT marg grth/ |
| Volex | VLX | 10 | /ROIC > 2yrs ago/Net debt down/ |

Source: FactSet and Investors' Chronicle

## US S&P 500 quality shares (out of 12 tests)

| Name | Ticker | Share price ($) | Mkt cap ($mn) | Enterprise value ($mn) | Fwd 12-mth PE | Cur. EV to forec't Ebitda | FCF yield | DY T12 | Forec't EPS gwth rate cur.yr | Forec't EPS gwth rate next yr | 3-mth share price mom. | Return on inv. capital fy (%) | Cash return on capital fy (%) | EBIT margin t12 | Net debt fy ($mn) | Net debt/ Ebitda fy |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Arista Networks | ANET | 186 | 57616 | 55212 | 27.8 | 22.6 | 0.8% | 0.0% | 34.7% | 10.5% | 8.6% | 30% | 11% | 36% | -2960 | -1.8 |
| Mastercard Class A | MA | 384 | 359365 | 373388 | 27.4 | 24.2 | 3.0% | 0.6% | 14.0% | 19.3% | -3.4% | 48% | 55% | 57% | 6796 | 0.5 |
| Paychex | PAYX | 116 | 41903 | 41211 | 24.0 | 17.1 | 3.7% | 2.9% | 10.2% | 6.8% | -6.3% | 37% | 41% | 41% | -759 | -0.3 |
| Visa Class A | V | 233 | 374992 | 486478 | 23.6 | 21.2 | 3.6% | 0.7% | 15.8% | 13.1% | -2.6% | 26% | 33% | 67% | 2102 | 0.1 |
| Adobe | ADBE | 541 | 246299 | 244881 | 30.5 | 25.2 | 2.9% | 0.0% | 16.2% | 13.0% | 4.7% | 25% | 42% | 34% | -1463 | -0.2 |
| Automatic Data Proc'g | ADP | 242 | 99565 | 101909 | 25.7 | 18.6 | 4.0% | 2.0% | 11.0% | 10.0% | 1.9% | 51% | 63% | 25% | 1443 | 0.3 |
| Alphabet Class A | GOOGL | 136 | 1597744 | 1641898 | 20.7 | 13.5 | 3.4% | 0.0% | 24.7% | 18.5% | 13.8% | 21% | 33% | 26% | -83785 | -0.9 |
| Alphabet Class C | GOOG | 137 | 1597744 | 1641898 | 20.9 | 13.5 | 3.3% | 0.0% | 24.7% | 18.5% | 14.4% | 21% | 33% | 26% | -83785 | -0.9 |
| Hubbell | HUBB | 280 | 15010 | 16170 | 17.6 | 13.4 | 3.0% | 1.6% | 43.2% | 5.6% | -17.2% | 13% | 15% | 18% | 1103 | 1.3 |
| McDonald's | MCD | 258 | 188101 | 236376 | 21.1 | 17.3 | 2.9% | 2.3% | 14.2% | 7.2% | -13.1% | 14% | 17% | 46% | 46115 | 3.8 |
| NVIDIA | NVDA | 414 | 1022259 | 1029192 | 27.2 | 33.1 | 0.4% | 0.0% | 220.4% | 58.6% | -9.1% | 12% | 16% | 33% | -1265 | -0.2 |
| Intuit | INTU | 507 | 142038 | 146454 | 30.1 | 22.8 | 3.3% | 0.6% | 13.6% | 13.7% | 3.1% | 10% | 21% | 22% | 3027 | 0.8 |
| W.W.Grainger | GWW | 691 | 34575 | 37316 | 18.2 | 13.4 | 3.0% | 1.0% | 21.4% | 7.0% | -9.9% | 32% | 28% | 16% | 2380 | 1.0 |
| Lamb Weston | LW | 88 | 12681 | 16138 | 14.5 | 10.1 | 0.8% | 1.2% | 26.0% | 6.3% | -22.8% | 25% | 19% | 17% | 3313 | 3.1 |
| AMETEK | AME | 142 | 32662 | 34501 | 21.4 | 17.2 | 3.1% | 0.7% | 10.0% | 7.4% | -10.4% | 12% | 12% | 25% | 2215 | 1.2 |

Source: FactSet and Investors' Chronicle

## US tests failed

| Name | Ticker | Tests passed | Tests failed |
|---|---|---|---|
| Arista Networks | ANET | 12 | / |
| Mastercard Class A | MA | 11 | /Net debt down/ |
| Paychex | PAYX | 11 | "/fc EBIT marg grth/ " |
| Visa Class A | V | 11 | /past EBIT marg grth/ |
| Adobe | ADBE | 11 | /ROIC > 2yrs ago/ |
| Automatic Data Processing | ADP | 11 | /Net debt down/ |
| Alphabet Class A | GOOGL | 11 | /Net debt down/ |
| Alphabet Class C | GOOG | 11 | /Net debt down/ |
| Hubbell | HUBB | 11 | /past EBIT marg grth/ |
| McDonald's | MCD | 10 | /past EBIT marg grth/ Net debt to Ebitda/ |
| NVIDIA | NVDA | 10 | /ROIC > 2yrs ago/Net debt down/ |
| Intuit | INTU | 10 | /ROIC > 2yrs ago/Net debt down/ |
| W.W. Grainger | GWW | 10 | /EBIT margin > median/Net debt down/ |
| Lamb Weston | LW | 10 | /Net debt down/Net debt to Ebitda/ |
| AMETEK | AME | 10 | /past EBIT marg grth/ Net debt down/ |

Source: FactSet and Investors' Chronicle

## Appendix: Alpha Quality screening criteria

Our quality screen has moved from focussing from return on equity (RoE), to looking at the ROIC to better reflect how well management teams are doing at firm's with diverse capital structures.

The new rules are as follows:

Compulsory tests (all screens)

- ROIC must have been above the median for the last three full financial years.
- Compound annual growth rate (CAGR) for expected sales over the next three years must be over 5 per cent.

Compulsory tests (just on small-cap, Aim, US S&P 500)

- Fwd PE (share price to forecast earnings per share for current financial year) not in the cheapest 10 per cent or the most expensive 10 per cent of companies.
- Forecast earnings per share growth this year and next.

Other tests when failed will be indicated in the "tests failed" columns of the tables below. The indicators to look out for are in brackets.

- EBIT (earnings before interest and taxation) margin forecast growth rate (over the next three years) above the median. (**fc EBIT marg grth**)
- ROIC is higher than two years ago. (**ROIC > 2yrs ago**)
- EBIT margin above the median. (**EBIT margin > median**)
- EBIT margin growth rate over the past three years is above the median. (**past EBIT marg grth**)
- Free cash flow (after leases) divided by net income averages over 100 per cent ove the past three years. (**cash conv**)
- Historic rate of sales growth (past three years) is positive. (**sales grth +ve**)
- Net debt at the last FY is lower than two years prior. (**net debt down**)
- Net debt to Ebitda (earnings before interest, tax, depreciation and amortisation) at last full year below 1.5 times. (**Net debt to EBITDA**)

Some of these tests would have been compulsory but, thanks to the distortive effect of the Covid-19 years, are used as guidance tests instead. Some tests are made compulsory for Small-cap and Aim companies, however. These are the **fc EBIT marg grth** and **cash conv** tests.

It might seem strange that US S&P 500 stocks are subject to more tests than UK large-cap and mid-cap shares. This is partly because there are many more quality companies in the US to screen from, but also was designed to filter some of the very expensive technology companies of which are so much more numerous stateside.

## The equities universe we screen from

Our UK equities universe methodology is inspired by the Numis family of UK indices (although we do not copy them exactly). The aim is to give investors a true overview of the genuine large-cap; mid-cap and small-cap companies that are exciting analysts and the markets.

We screen against the S&P 500 for large and mega-cap US companies.

### Investors' Chronicle UK screening cut-offs:

**Large cap:** The top 80 per cent of the UK main market's market capitalisation.

**Mid cap:** The next 15 per cent of UK main market capitalisation (80th to 95th percentile)

**Small cap:** The bottom five per cent of the main market by capitalisation with a £35mn lower cut-off.

**Aim:** We cut off the Alternative market by excluding all companies below £35mn market cap.

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Alpha Editor: James Norrington
Alpha Production Editor: Sameera Hai Baig

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