Investors' Chronicle | Alpha

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

AlphaScreens: the quest for quality

25 May 2023

Inflation continues to wobble the tightrope

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 UK's awful inflation numbers have once again upset the apple cart for domestic assets. Readers should by now be able to recite in their sleep that when central banks raise interest rates, bond yields must rise and therefore prices (which move inversely with yields) must fall. The higher cost of money also affects discount rates for investors so share valuations require a re-set. When inflation disappoints like it has this week, the assumptions bond investors made about the pace of central bank tightening and the timing of a pivot to looser monetary policy get ripped up; this forces a repricing which has a knock-on effect to other assets like shares.

Lower energy prices may now have the headline Consumer Prices Index (CPI) rising at 'only' 8.7 per cent year on year to April 2023 (down from 10.1 per cent YoY to March), but that's mostly down to calmer energy markets. Food prices are an eye-watering 19 per cent more expensive than a year ago. When you ignore volatile items like food and energy, the rate of 'core' inflation is getting worse - up from 6.2 to 6.8 per cent.

Central banks can't do much about energy and food security - but they can restrict the supply of money and make borrowing more expensive. This increases companies' cost of capital and chokes off consumer credit, dampening demand, and hopefully gets core inflation under control. Unfortunately, the Bank of England has more work to do and won't be able to cut rates as soon as hoped.

Quality shares aren't a hedge against inflation, but they do offer investors one of the best ways to outperform rising prices over the longer term. Companies with pricing power, wide 'moats', high margins and a proven ability to deliver above average returns on invested capital (ROIC) will hold investors in good stead provided they buy the shares at a reasonable valuation.

This value part of the puzzle was missing in the run-up to the phase of aggressive interest rate hikes that gathered pace in 2022. Expensive quality stocks sold off savagely along with bonds last year, but now the decision whether to buy certain investments is more nuanced. Bad inflation prints like the UK had for April causes a rethink of valuations, but where quality shares are already cheap relative to their history against interest rates, there is a bit more of a margin of safety.

Whereas it was understandable to step back from quality shares last year, now there may be a case for some shares to buy and hold, trusting the quality of the underlying businesses to win through. This is where your individuality as an investor is important: a big part of the buy case is always your personal objectives and time horizon.

- When interpreting the results of a quality screen like ours, it is always prudent to consider whether a company ranks well because it has just enjoyed a good cyclical period or perhaps it has been enjoying a recovery run which it may struggle to sustain. When it comes to **Burberry (BRBY)**, the UK luxury fashion retailer, questions about the durability of its recovery were raised by Robin Hardy when he took a deep dive look at the company back in January. Since then a decent set of preliminary full year results for 2022-23 and possibilities for sales to recover in China since its re-opening hasn't dispelled lingering doubts that this is a business not quite at the top table of the famously recession-resistant luxury goods market. Therefore, although ROIC and margins are impressive, there isn't quite the moat for a nailed on quality investment case.

- Other UK large caps ranking well in the screen include several businesses that are on the Alpha quality shares watchlist. Many of these companies are true buy-and-hold compounders, so the issue is one of valuation both in terms of their history relative to the market and, crucially right now, relative to interest rates. The likes of engineering/industrial companies **Spirax-Sarco (SPX)** and **Halma (HLMA)** are reasonably valued against their history but are still expensive versus rates.

- In the mid-cap space IT and software development business **Kainos (KNOS)** enjoyed a spike in its share price on the back of a stellar set of full-year results (revenue up almost a quarter and profit before tax up 18 per cent) but the shares have pulled back along with the rest of the market. This should pique investor interest as there is room for an upgrade cycle here and, although rated on close to 27 times forward earnings, the company is not expensive compared to its history versus the market and has been inexpensive versus bond yields. Although, the latest sell-off in gilts (UK government bonds), does highlight the short-term macro risks that can cause valuation assumptions to adjust.

- Our US screen is very much reflective of some of the new quality growth industries of the 21st century - with the screen topped by silicon design and verification business **Synopsys (US:SNPS)** and cloud-connectable medical device specialist **ResMed (US:RMD)**. It is also not a surprise to see the early pace-setters in Artificial Intelligence like Microsoft **(US:MSFT)** and Alphabet **(US: GOOGL)** ranking highly. Although the glamour stock of the day, **Nvidia (US:NVDA)** which leads in the graphics processing units used in deep learning and other AI computational processes, is filtered out for being too expensive.

Quality screen results tables

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't Ebitda	FCF yield	DY t12	Forec't EPS grwth rate cur. yr	Forec't EPS grwth rate next yr	3-mth share price mom.	Return on inv. EBIT capital fy (%)	Cash return on capital fy (%)	EBIT margin t12	Net debt fy (£mn)	Net debt/ Ebitda fy
Burberry	BRBY	2258	8540	9227	17.6	9.2	7.0%	2.7%	2.8%	12.0%	-8.7%	18%	27%	20%	460	0.5
Halma	HLMA	2380	9036	9513	29.0	22.0	2.3%	0.8%	14.5%	8.5%	8.4%	15%	14%	18%	275	0.7
RELX	REL	2492	47325	54452	21.6	15.7	5.0%	2.2%	8.6%	10.5%	-2.0%	17%	26%	28%	6396	2.0
Experian	EXPN	2827	25984	29426	23.9	14.9	4.9%	1.5%	8.3%	9.7%	-3.2%	15%	24%	24%	2970	1.9
Diageo	DGE	3538	79617	96885	19.9	16.4	3.4%	2.2%	19.6%	7.0%	-1.4%	15%	18%	31%	13959	2.6
Spirax-Sarco Eng.	SPX	11100	8171	8948	26.8	18.3	1.5%	1.4%	6.6%	8.7%	-6.8%	14%	14%	20%	756	1.9
Sage	SGE	859	8799	9539	25.9	18.6	3.1%	2.2%	21.7%	10.8%	14.7%	12%	13%	18%	733	1.7

Source: FactSet and Investors' Chronicle

UK large-cap tests failed

Name	Ticker	Tests passed	Tests failed
Burberry	BRBY	9	/Net debt down/
Halma	HLMA	9	/past EBIT marg grth/
RELX	REL	8	/past EBIT marg grth/ Net debt to Ebitda/
Experian	EXPN	8	/past EBIT marg grth/ Net debt to Ebitda/
Diageo	DGE	7	/past EBIT marg grth/ Net debt down/Net debt to Ebitda/
Spirax-Sarco Engineering	SPX	7	/cash conv/Net debt down/Net debt to Ebitda/
Sage	SGE	6	/ROIC > 2yrs ago/past EBIT marg grth/ Net debt down/Net debt to Ebitda/

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 grwth rate cur. yr	Forec't EPS grwth 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
Auto Trader	AUTO	623	5701	5960	22.4	18.4	4.6%	1.3%	2.0%	4.5%	3.5%	50%	57%	64%	-42	-0.1
Games Workshop	GAW	9440	3107	3067	23.2	15.4	3.4%	3.7%	-0.3%	4.8%	2.2%	50%	48%	39%	-23	-0.1
Kainos	KNOS	1292	1610	1516	27.3	19.1	3.7%	1.8%	9.1%	14.4%	-7.3%	35%	53%	13%	-107	-2.0
Rotork	ROR	332	2855	2749	22.1	15.1	1.8%	2.0%	14.4%	8.8%	1.2%	16%	10%	21%	-106	-0.7
Rightmove	RMV	548	4485	4557	21.6	17.2	4.3%	1.6%	3.3%	8.9%	-2.9%	253%	256%	73%	-31	-0.1
Moneysupermkt.com	MONY	261	1400	1467	16.4	11.6	7.1%	4.5%	6.7%	11.2%	14.3%	25%	38%	23%	56	0.5
Diploma	DPLM	2944	3946	3929	23.6	15.4	3.0%	1.9%	13.3%	3.6%	6.4%	10%	14%	15%	398	1.9
QinetiQ	QQ	372	2155	1966	13.2	8.5	5.9%	2.0%	24.3%	9.7%	9.0%	9%	19%	10%	-226	-1.3

Source: FactSet, Investors' Chronicle

UK mid-cap tests failed

Name	Ticker	Tests passed	Tests failed
Auto Trader	AUTO	9	/past EBIT marg grth/
Games Workshop	GAW	9	/ROIC > 2yrs ago/
Kainos	KNOS	9	/ROIC > 2yrs ago/
Rotork	ROR	8	/past EBIT marg grth/ Net debt down/
Rightmove	RMV	7	/past EBIT marg grth/ cash conv/Net debt down/
Moneysupermarket.com	MONY	7	/ROIC > 2yrs ago/past EBIT marg grth/ Net debt down/
Diploma	DPLM	7	/ROIC > 2yrs ago/Net debt down/Net debt to Ebitda/
QinetiQ	QQ	6	/ROIC > 2yrs ago/EBIT margin > median/past EBIT marg grth/ cash conv/

Source: FactSet and Investors' Chronicle

Continued below

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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' Ebitda	FCF yield	EV/ sales	DY t12	Forec't EPS grwth rate cur. yr	Forec't EPS grwth 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
Medica	MGP	211	259	261	19.2	13.8	2.5%	3.39	1.3%	19.7%	15.5%	31.9%	12%	14%	12%	0	0.0
A.G. BARR	BAG	517	579	531	16.4	9.2	3.7%	1.67	2.5%	3.9%	7.7%	-6.0%	13%	14%	14%	-49	-0.9
FDM	FDM	685	750	719	17.4	11.3	4.7%	2.18	5.3%	4.2%	3.5%	-15.5%	39%	40%	14%	-33	-0.6

Source: FactSet and Investors' Chronicle

Small-cap tests failed

Name	Ticker	Tests passed	Tests failed
Medica	MGP	12	/
A.G. BARR	BAG	11	/past EBIT marg grth/
FDM	FDM	10	/past EBIT marg grth/ Net debt down/

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 grwth rate cur. yr	Forec't EPS grwth 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
Cerillion	CER	1190	351	332	28.1	20.5	3.3%	10.1	0.8%	11.4%	12.2%	9.2%	35%	46%	41%	-16	-1.0
Elixirr Int'l	ELIX	481	222	235	13.5	9.2	6.1%	3.3	2.2%	14.1%	6.7%	-1.8%	13%	16%	23%	-15	-0.8
YouGov	YOU	1050	1171	1147	25.0	15.4	5.1%	5.2	0.7%	64.9%	12.3%	15.6%	13%	48%	19%	-25	-0.4

Source: FactSet and Investors' Chronicle

Aim tests failed

Name	Ticker	Tests passed	Tests failed
Cerillion	CER	12	/
Elixirr International	ELIX	12	/
YouGov	YOU	11	/Net debt down/

Source: FactSet and Investors' Chronicle

Continued below

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

Name	Ticker	Share price ($)	Mkt cap ($mn)	Enterprise value ($mn)	Fwd 12-mth PE	Cur. EV to forec't Ebitda	FCF yield	DY t12	Forec't EPS grwth rate cur. yr	Forec't EPS grwth rate next yr	3-mth share price mom.	Return on inv. capital fy (%)	Cash return on capital fy (%)	EBIT margin t12	Net debt fy ($mn)	Net debt/ Ebitda fy
Synopsys	SNPS	393	59812	59857	33.6	28.2	2.7%	0.0%	21.8%	14.0%	7.6%	17%	31%	20%	-911	-0.6
ResMed	RMD	223	32699	34299	30.6	25.5	0.7%	0.8%	11.9%	13.8%	3.5%	20%	9%	28%	644	0.5
Microsoft	MSFT	315	2344112	2327986	29.0	22.9	2.7%	0.8%	4.4%	14.6%	23.7%	32%	39%	41%	-26357	-0.3
Visa Class A	V	225	363421	473396	24.0	20.7	3.7%	0.7%	14.6%	13.9%	1.6%	26%	33%	67%	2102	0.1
Paychex	PAYX	109	39241	38694	23.7	17.4	3.5%	2.9%	13.5%	7.5%	-2.2%	36%	39%	40%	-368	-0.2
Adobe	ADBE	370	169912	168866	22.5	17.9	4.2%	0.0%	13.0%	13.4%	6.7%	25%	42%	33%	-1463	-0.2
Alphabet Class A	GOOGL	123	1452334	1594198	21.2	13.7	3.5%	0.0%	18.4%	18.1%	34.8%	21%	33%	26%	-83785	-0.9
Alphabet Class C	GOOG	123	1452334	1594198	21.3	13.7	3.5%	0.0%	18.2%	18.1%	35.4%	21%	33%	26%	-83785	-0.9
Cintas	CTAS	461	46842	50461	32.4	22.9	2.7%	1.0%	13.9%	10.9%	5.4%	22%	27%	20%	2878	1.4
Mastercard Class A	MA	374	351392	365386	28.3	23.6	3.0%	0.6%	15.4%	18.8%	5.1%	48%	55%	57%	6796	0.5
Automatic Data Proc'g	ADP	216	89049	91122	24.3	18.5	3.2%	2.1%	16.6%	9.4%	-3.2%	38%	40%	24%	2107	0.5
McDonald's	MCD	286	209077	256836	24.9	19.3	2.6%	2.0%	9.7%	9.3%	7.3%	14%	17%	45%	46115	3.8
Intuit	INTU	450	126190	130221	29.6	23.4	2.9%	0.7%	16.7%	12.0%	9.2%	12%	22%	22%	4259	1.2
Starbucks	SBUX	100	115030	136728	26.0	19.3	3.6%	2.0%	16.1%	19.1%	-3.1%	23%	43%	13%	20622	2.8
W.W. Grainger	GWW	660	33092	35881	17.9	12.9	3.2%	1.0%	20.4%	7.6%	0.3%	32%	28%	15%	2380	1.0
IDEX	IEX	205	15461	16606	23.5	17.8	3.1%	1.2%	4.5%	6.2%	-9.4%	14%	13%	24%	1157	1.3

Source: FactSet and Investors' Chronicle

US tests failed

Name	Ticker	Tests passed	Tests failed
Synopsys	SNPS	12	/
ResMed	RMD	12	/
Microsoft	MSFT	11	/Net debt down/
Visa Class A	V	11	/past EBIT marg grth/
Paychex	PAYX	11	/past EBIT marg grth/
Adobe	ADBE	11	/ROIC > 2yrs ago/
Alphabet Class A	GOOGL	11	/Net debt down/
Alphabet Class C	GOOG	11	/Net debt down/
Cintas	CTAS	11	/Net debt down/
Mastercard Class A	MA	10	/past EBIT marg grth/ Net debt down/
Automatic Data Processing	ADP	10	/past EBIT marg grth/ Net debt down/
McDonald's	MCD	10	/past EBIT marg grth/ Net debt to Ebitda/
Intuit	INTU	10	/ROIC > 2yrs ago/Net debt down/
Starbucks	SBUX	10	/EBIT margin > median/Net debt to Ebitda/
W.W. Grainger	GWW	10	/EBIT margin > median/Net debt down/
IDEX	IEX	10	"/fc 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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ISSN 0261-3115.