Investors' Chronicle | Alpha

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Alpha shares analysis

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Quality shares still don't come cheap

This valuation update for our quality shares watchlist suggests that even though many companies aren't expensive by their own medium-term history, the secular shift in interest rate policy means they are still dear relative to other assets.

The capital asset pricing model (CAPM) remains hugely influential: it helps inform investors what to pay for assets and companies use it to work out their cost of capital when making project funding and capital expenditure decisions. Central to the theory is the idea of a risk-free rate of return typically taken to be the yield on a high quality benchmark government bond. As governments that can print their own money will never default on the cash flows due to bondholders, an investor who holds the instrument to maturity is certain of getting the nominal return they expected when they bought it.

CAPM posits assets producing less certain cash flows must offer investors a 'risk premium' over and above the risk-free rate. Therefore, shares ought to be priced so that the spread in their implied rate of return (based on expectations of capital growth plus dividends) is above the risk-free rate to an extent commensurate with the perceived riskiness.

As government bond yields have risen, so the required rate of return from shares has had to rise, which can happen one of two ways: either companies must become more profitable or their shares must be cheaper to begin with. In many cases, company earnings are facing economic pressures, and although one hallmark of quality is maintaining profitability in hard times, the prospects of actually growing businesses against a tough backdrop are more limited. Invariably, in a high rate environment, the shares of many companies are therefore still at risk of downward ratings, despite their underlying quality.

When creating the Alpha quality shares watchlist, our Secret Buy-sider looked at the valuation of quality shares both in terms of their own history and versus government bond yields.

In the first instance, companies' enterprise value was divided by the full-year consensus forecast of earnings before interest, tax, depreciation and amortisation (Ebitda). Enterprise value (EV) is the sum of market value of equity (market capitalisation) and net debt - giving a true reflection of value based on the claims of all investors (shares and bondholders) on the company. Ebitda isn't perfect, but it serves as a decent proxy for the profits a company reports that are likely to be cash.

The spread between each company's EV/Ebitda value and the aggregated figure for the FTSE All Share was compared to a five-year median. If the current spread was 1.5 points above the median the company was classed as expensive, 1.5 points below and it was cheap and anything in that range it was fair value.

Judged by this metric, several of the companies in our quality shares watchlist were still cheap up to the end of February. The likes of **Rightmove (RMV)**, data business **YouGov (YOU)**, gaming developer **Team17 (TM17)**, drinks giant **Diageo (DGE)**, and the industrial components and safety device manufacturer **Halma (HLMA)** were all attractively priced relative to their history. Out of 25 companies on our watchlist, only four are expensive versus their five-year median EV/Ebitda.

Yet that belies the macro picture and the fact the UK 10-year gilt yield was over 3.7 per cent at the end of February. The second valuation measure used by our Secret Buy-Sider painted a very different picture for some companies.

Using a metric called the Enterprise Earnings Yield (EEY), which is obtained by dividing one by the EV/Ebitda multiple and comparing the spread to the risk-free gilt yield, helps contextualise the EV/Ebitda ratings after the fashion of the CAPM. Looking at the five-year median spread of EEY to benchmark yields, the threshold is that a current spread 1.5 per cent greater than the median implies cheap value; spreads within 1.5 per cent of the median indicate fair value; and spreads more than 1.5 per cent less than the median means the shares are expensive.

On this relative basis not a single company in our watchlist was classified as cheap to the end of February. Furthermore, several that appear cheap on the other EV/Ebitda measure are actually expensive when higher rates are taken into account. These include Rightmove and Team17 and, overall, 16 out of 25 companies are expensive.

This paints a good picture of what the quality factor is facing as a style of investing. Companies may in some instances be cheap relative to the very high valuations attained when interest rates were low but are still not offering investors an attractive risk premium relative to government bond yields.

But the disconnect in some cases between the two valuation methods is something that will eventually be a source of opportunity. Inflation isn't tamed so it is probably premature to predict a policy pivot by central banks but when they do, the likelihood of reversion to long-run EV/Ebitda multiples will be bullish for quality shares. Although, it must be said that the monetary policy regime of the past decade before the inflation surge of 2022 had to be tackled, may not be exactly where we head back to and valuations will stick at equilibriums short of what was seen a few years ago.

Ticker	Name	Sector	Bucket	Valuation vs. history (EV/EBITDA)	Valuation vs. rates
RMV	Rightmove	Communication services	Mid cap	Cheap	Expensive
MONY	Moneysupermarket.com	Communication services	Small cap	Fair	Fair
YOU	YouGov	Communication services	Aim	Cheap	Fair
TM17	Team17	Communication services	Aim	Cheap	Expensive
CPG	Compass Group	Consumer discretionary	Large cap	Fair	Expensive
IHG	InterContinental Hotels Group	Consumer discretionary	Large Cap	Fair	Expensive
DGE	Diageo	Consumer staples	Large cap	Cheap	Expensive
ULVR	Unilever	Consumer staples	Large cap	Fair	Expensive
IMB	Imperial Brands	Consumer staples	Large cap	Fair	Fair
BATS	British American Tobacco	Consumer staples	Large cap	Fair	Fair
CCH	Coca-Cola HBC AG	Consumer staples	Large cap	Fair	Fair
STJ	St James's Place	Financials	Large cap	N/a	N/a
INDV	Indivior	Health care	Mid cap	Expensive	Fair
EXPN	Experian	Industrials	Large cap	Fair	Expensive
REL	RELX	Industrials	Large cap	Expensive	Expensive
SPX	Spirax-Sarco Engineering	Industrials	Large cap	Fair	Expensive
RS1	RS Group	Industrials	Mid cap	Fair	Fair
ROR	Rotork	Industrials	Mid cap	Fair	Expensive
IMI	IMI	Industrials	Mid cap	Fair	Expensive
JDG	Judges Scientific	Industrials	Aim	Fair	Expensive
HLMA	Halma	Industrials	Large cap	Cheap	Expensive
SGE	Sage Group	Information technology	Large cap	Fair	Expensive
KNOS	Kainos Group	Information technology	Mid cap	Expensive	Expensive
FDM	FDM Group Holdings	Information technology	Small cap	Expensive	Fair

CER	Cerillion	Information technology	Aim	Fair	Expensive

Source: FactSet, Investors' Chronicle

How have these companies' operational and financial performances been?

Of course, as well as considering how expensive these shares are, the key question remains whether they are still maintaining the quality characteristics that saw them included in our watchlist in the first place.

In the wake of recent results reporting, **Rightmove (RMV)**, industrial company **IMI (IMI)** which is a fluid and motion control technology specialist, industrial components engineering firm **Spirax-Sarco (SPX)**, data and research business **RELX (REL)** and **Halma (HLMA)** are examples of large-cap companies which still meet all of our key quality requirements (see appendix) to deliver above median return on invested capital (ROIC), improved ROIC compared to two years ago, and also above average margins of earnings before interest and taxation (Ebit).

Further down the size scale the same is true of software business **Kainos (KNOS)**, which will report full-year results for its 2022-23 financial year in May. Across seven broker estimates, FactSet data shows no revisions to estimates for the full-year earnings per share from when analysts made forecasts mostly in the wake of the November interim results.

Some companies that have scored well on quality thanks to their defensive nature and inelastic demand for their products conferring pricing power. These are immutable characteristics of tobacco companies, although the limited growth potential for core products and a need to invest in alternatives means it is debatable whether they are truly 'quality' shares.

Sector composition of the watchlist:

There are eleven sectors under the global industry classification (GICs) framework. These are: Consumer Staples, Communication Services, Health Care, Industrials, Information Technology, Consumer Discretionary, Energy, Materials, Utilities, Financials and Real Estate. Sectors tend to have common business models and with these common business models common ROIC characteristics.

Some sectors are naturally high returning (Consumer Staples, Information Technology) whilst others are naturally low returning (Energy, Utilities). Because of this business model dynamic, some sectors are over-represented in the Investors' Chronicle Alpha quality portfolio (Industrials and Information Technology), whilst some are

underrepresented (Financials and Health Care) and some not present at all (Energy, Materials, Real Estate and Utilities).

The table below details the general ROIC characteristics alongside a brief comment for all 11 GICs sectors.

Included sectors	Sector	ROIC characteristics	Comment
	Communication services	Mixed	Wide range of business models
	Consumer discretionary	High returning	High returning but cyclical and no 'right' to exist
	Consumer staples	High returning	Tend to have ability to build moats
	Financials	Low returning	Lots of capital required (ROE) better
	Health Care	Mixed	Wide range of business models
	Industrials	Mid-high returning	Niche end markets and dominant shares lead to high returns
	Information technology	High returning	Software high returning, hardware less so

Missing sectors	Sector	ROIC characteristics	Comment
	Energy	Low returning	Price takers, large capital bases
	Materials	Low returning	Some potential but no UK names meet criteria
	Real estate	Low returning	Lots of capital required (ROE better)
	Utilities	Low returning	Huge asset base and earnings are regulated limiting growth

Our updated EV/Ebitda and EEY valuation tables are below

Ticker	Name	12-mth fwd EV/EBITDA (28.02.2023)	5-yr median spread versus All Share	Spread to All Share (28.02.2023)	vs. history
FTSE All Share		**7.0**	-		
RMV	Rightmove	17.6	13.9	10.6	Cheap
MONY	Moneysupermarket.com	10.1	3.3	3.1	Fair
YOU	YouGov	12.2	11.7	5.2	Cheap
TM17	Team17	12.0	12.3	5.0	Cheap
CPG	Compass Group	12.1	5.2	5.1	Fair
IHG	InterContinental Hotels	13.7	6.7	6.7	Fair
DGE	Diageo	15.5	10.2	8.5	Cheap
ULVR	Unilever	12.5	4.9	5.5	Fair
IMB	Imperial Brands	6.4	-0.6	-0.6	Fair
BATS	British American Tobacco	7.6	1.2	0.6	Fair
CCH	Coca-Cola HBC AG	7.4	1.7	0.4	Fair
STJ	St James's Place	N/a	N/a	N/a	N/a
INDV	Indivior	7.4	-1.3	0.4	Expensive
EXPN	Experian	14.4	8.9	7.4	Fair
REL	RELX	15.5	6.7	8.5	Expensive
SPX	Spirax-Sarco Engineering	18.8	12.0	11.8	Fair
RS1	RS Group	10.2	4.4	3.2	Fair
ROR	Rotork	15.0	7.5	8.0	Fair
IMI	IMI	10.4	2.1	3.4	Fair
JDG	Judges Scientific	17.7	10.8	10.7	Fair
HLMA	Halma	19.0	15.2	12.0	Cheap
SGE	Sage Group	16.2	8.1	9.2	Fair
KNOS	Kainos Group	22.0	16.7	15.0	Expensive
FDM	FDM Group Holdings	13.8	10.1	6.8	Expensive
CER	Cerillion	18.3	10.1	11.3	Fair

Source: Investors' Chronicle, FactSet

Ticker	Name	5-yr median EEY spread to gilts	Spread now	vs. rates
RMV	Rightmove	3.4	2.0	Expensive
MONY	Moneysupermarket.com	7.7	6.2	Fair
YOU	YouGov	4	4.5	Fair
TM17	Team17	4.2	4.6	Expensive
CPG	Compass Group	6.5	4.5	Expensive
IHG	InterContinental Hotels	5.4	3.6	Expensive
DGE	Diageo	4.3	2.7	Expensive
ULVR	Unilever	6.7	4.3	Expensive
IMB	Imperial Brands	12.9	11.8	Fair
BATS	British American Tobacco	10.0	9.5	Fair
CCH	Coca-Cola HBC AG	9.1	9.7	Fair
STJ	St James's Place	N/a	N/a	N/a
INDV	Indivior	9.6	9.7	Fair
EXPN	Experian	4.8	3.2	Expensive
REL	RELX	5.7	2.7	Expensive
SPX	Spirax-Sarco Engineering	4.8	3.2	Expensive
RS1	RS Group	5.7	2.7	Fair
ROR	Rotork	3.8	1.6	Expensive
IMI	IMI	6.8	6.0	Expensive
JDG	Judges Scientific	4.1	1.9	Expensive
HLMA	Halma	3.4	1.5	Expensive
SGE	Sage Group	5.4	2.4	Expensive
KNOS	Kainos Group	2.9	0.8	Expensive
FDM	FDM Group Holdings	4.5	3.5	Fair
CER	Cerillion	6.1	1.7	Expensive

Source: Investors' Chronicle, FactSet

Investors' Chronicle Alpha quality screen rules

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 **forecast EBIT margin growth** and **cash conversion** 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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