

Alpha shares analysis

13 October 2022

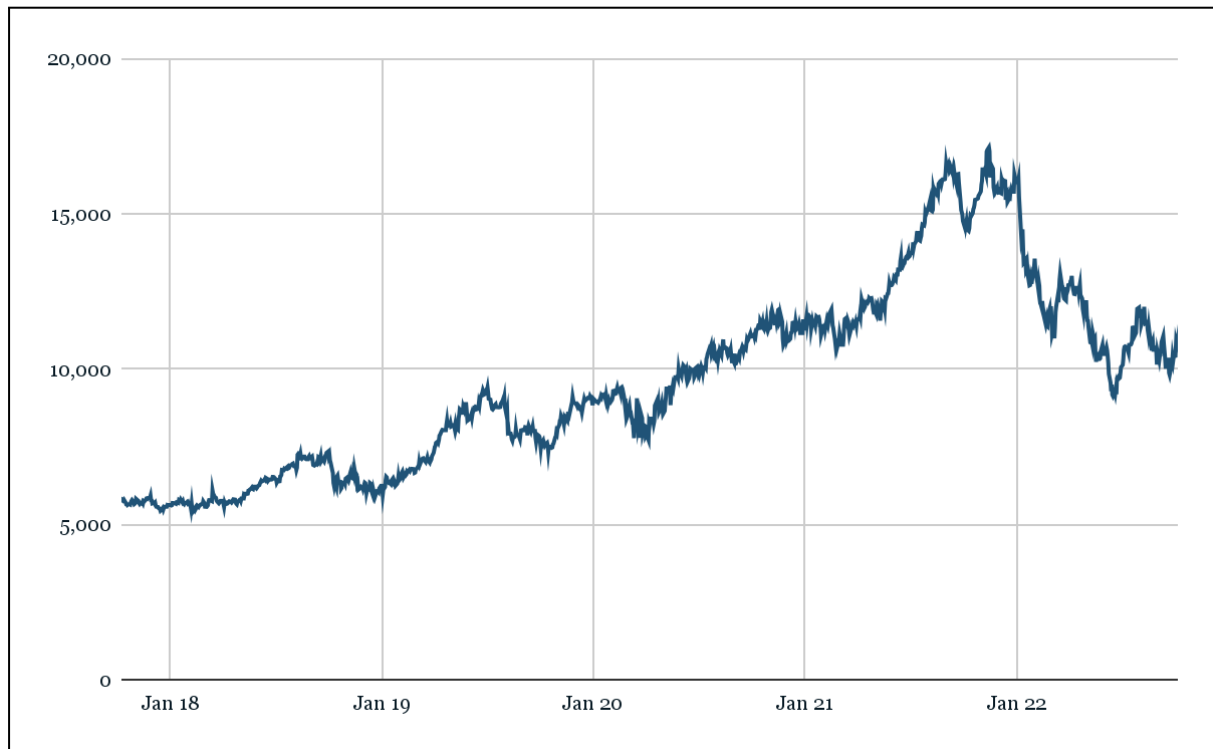
Confounding compounders?

This week we look at some so-called 'compounder' stocks: companies that exhibit strong, counter-cyclical and even recession-resistant growth purely by the strength of their business model. All three stocks have made exceptional returns for investors over the last decade and more, but is the magic still there as we head into considerably choppier economic waters?

- **Spirax Sarco (SPX)** – a well-focused industrial company with an excellent track record even through the global financial crisis and Covid, Spirax has two key strengths. First, the bulk of its revenues are funded out of its customers' operating rather than capital expense; and second, its customers have a heavy skew towards more defensive industries such as biotech and pharma. Long term, the average annualised rate of total shareholder return (TSR) has been an impressive 24 per cent, even after a steep de-rating year to date in 2022, with the shares down by around one-third. Are there any signs as to what might drive the share price back up for this popular long-term core holding?
- **Halma (HLMA)** – Halma has an excellent long-term record: 43 years of >5 per cent dividend growth and 19 unbroken years of profit growth even through Covid and the GFC. This is a business aggressively seeking growth through an equal blend of organic and acquisitive expansion. While presenting a focused, three-divisional structure, Halma's operations are extremely diverse and operate in micro markets, leaving it hard for external investors to see where growth arises or to allow them to stack the business against global benchmarks. In addition, the high level of acquisitions (13 last year and a typical target of 10 a year) means this is an ever shifting entity.
- **RELX (REL)** – this is a tale of wholesale reinvention as the company has shifted from being a print publisher to become a digital provider of business critical data that has delivered impressive returns for investors over the long term. The conversion process has not largely run its course, so sources of growth are less obvious here and while headline EPS is still on a positive trajectory, perhaps too much of this is from FX tailwinds and the rebound from heavy Covid-induced losses in the Exhibitions business. There is a less demanding rating (21x PE) than the other stocks here, but the pace and profile of RELX's growth do demand a discount.

Analyst: **Robin Hardy**

Spirax Sarco – a great stock overbought?



Source: FactSet

Snapshot

Spirax is a specialist engineering business with a market value of c.£8bn placing it in the FTSE100 index, and this is an old stager with the shares first listed in 1959. It comprises three divisions servicing a wide range of sectors and businesses all with long-term structural growth characteristics, which has allowed the group to post consistently strong performance even in weak economic conditions. For example, in 2009 during the global financial crisis (GFC,) constant currency sales (i.e. backing out the impact of currency translations) only fell by 7 per cent (the average for the industrial sector was a drop of nearer 30 per cent). Through the pandemic there was a similar pattern with sales only dropping 3 per cent. Spirax is a high margin business: earnings before interest and tax (EBIT) returns are above 20 per cent and above 30 per cent in its best businesses. Furthermore, Spirax holds market leadership in its core markets. Despite this, its market shares are moderate (no higher than 16 per cent) and its markets are materially fragmented with the bulk of competition being smaller, local and typically privately-owned businesses.

Operations

Spirax has three operating divisions – essentially two of them work in the same field, but provide a different delivery mechanism. The end customers of the group cover a

substantial part of the industrial economy with the main fields of work being for both larger and smaller players in the following industries:

Pharmaceutical & Biotechnology, Food & Beverages, OEM Machinery, Oil & Gas, Chemicals, Power Generation, Healthcare, Water & Wastewater, Buildings, Mining & Precious Metal Processing, Semiconductors and Transport.

Pharma is the largest segment at a little over one-quarter of sales followed by Food & Beverages at around 20 per cent and OEM (original equipment manufacturing) at just over 10 per cent. These end markets are in structural growth or otherwise very defensive industries.

So there isn't much that Spirax does not touch in terms of production and processing and the nature of these industries naturally means a large global footprint. Spirax operates in 67 countries with FactSet estimating that around a quarter of the group's revenues come from the USA followed in importance by mainland China (about half the size of the US).

The other key strength of the business model is where in their customers' spending profiles Spirax's products fit. Only around 15 per cent of the group's revenue is derived from larger capital investment projects (deemed to be schemes with a value of more than £100,000); these are the areas of spending that are most likely cut or reduced during periods of economic headwinds. The remainder of the group's income flows from customers' core operating expenditure, or OPEX. This is spending on repair and maintenance covered by depreciation charges or small investment projects (£10k-£50k) that would cover items such as upgrades or small additive schemes. The items that fall under OPEX spending have a typical value of just £1,300. Given the size of many of its customers, this is an almost incidental sum and strongly underscores why its customers are likely to continue buying the group's products through thick and thin.

In the current inflationary environment it is important to be confident that businesses can pass through as much of their own inflation as possible and with Spirax there is a long history of its customers being willing to accept higher manufacturing costs being fully passed through. This is driven purely by reputation and quality of product and service rather than being enshrined into contracts through elevator clauses. Therefore, margins across all disciplines look to be highly defensible.

Spirax's operations fall into the following three disciplines:

Steam specialities – the first thought that might come to mind when an engineering stock works in the field of steam is turbines and power generation but that is not the case here.

Spirax's focus is on thermal management: the fine control of temperature levels and stability in sensitive manufacturing processes. Steam heating is regarded by many industries as the most efficient, effective and micro-controllable form of heating delivery and control and is able to deliver across a wide range of temperatures, running well above 100°C (known as superheated steam). Spirax makes the controls, flow/delivery mechanisms, metering and heat transfer interfaces. In addition to delivery of heat, the group's systems are also capable of transferring heat away from high temperature manufacturing processes.

In addition to thermal management, 'clean' steam is used in many industries for cleaning and sterilisation as the high temperatures make the steam inherently sterile.

This is the largest division in the group with revenues of around £750mn, which is a little over half the group total, and showed an increase of 12 per cent on an organic basis (i.e. stripping out FX movements and contributions from new acquisitions). Margins are high at around 25 per cent at the EBIT level. This gives a market share of the assessed addressable market of around 16 per cent.

One fly in the ointment for this division is that still by far the cheapest and most efficient way to generate steam is to use fossil fuel burning boiler systems. Today, there are limited alternatives and there is such a vast infrastructure in place across the world that any transition away from fossil fuels and steam systems is likely to be slow. In many emerging economies, which provide the highest growth rates for this division, and in China the pace of change away from fossil fuels is very slow.

In China, growing economic pressure potentially prolongs this process as the Green Economy plans are widely expected to be pushed back. While ultimately the various end industries may have to adopt a different approach, that is seen as being a very long way out and significantly beyond most investors' time horizons. This does mean, however, that investors with a very strong focus on environment, social and governance (ESG) may have some issue with this business.

While slow, changes in thermal management solutions are emerging and Spirax has invested in businesses serving newer and alternative technologies in thermal management.

Electric thermal solutions (ETS) – the aforementioned newer technologies are primarily electrical heating and cooling systems, an expanding alternative to steam. This is a fairly recent addition to the group, coming through the group's largest acquisition to date when it acquired US operator Chromalox for \$415mn in May 2017. Since then two further

acquisitions have enlarged this operation: French insulated cable manufacturer Theromcoax in 2019 (£138mn) and another French business Vulcanic, more similar to the broad spectrum services in Chromalox. The Vulcanic acquisition (at £226mn) was only completed at the end of September 2022.

This division provides, essentially, the same suite of solutions as the steam operations, but with starkly different technology, infrastructure and control systems. ETS systems are also capable of running at significantly higher temperatures (>600°C whereas Spirax's steam systems top out at around 250°C) which means that the operational scope of the group has been expanded. ETS systems are also more suited to remote access controls which allows services to be installed in more aggressive environments and/or remote locations than steam.

It also has the advantage that the energy input can be totally free of fossil fuels using either networked renewables or locally generated electricity from the likes of hydrogen fuel cells. Electrical solutions are more expensive to operate than steam as gas and oil remain materially cheaper per KWh of energy input. However, increasingly businesses and government agencies are placing an effective price on a process's carbon footprint. And in many areas (especially with governments as the client) customers are beginning to require that manufacturing processes migrate to greener solutions as a condition of doing business.

ETS is, understandably, materially smaller than the steam operations with pro-forma revenues (taking Vulcanic into account) of around £250mn, around 16 per cent of the group total. Margins are materially lower than steam with just 13 per cent reported last year although much of this stems from heavy losses in Chromalox's EMEA (Europe, Middle East and Africa) operations primarily due to a very poorly performing plant at Soissons, France. This has led to the EMEA business (excluding Vulcanic) showing negative margins in excess of 20 per cent; the core of this division in the USA is delivering returns of a little over 20 per cent EBIT. The problems in France are being addressed (inevitably slowly because of strong union issues), with the process expected to complete by the end of 2022.

Although new to this space, Spirax already has a market share of around 7.5 per cent and clearly has an ambition through acquisition to grow this side of its business. Electrical heating is growing faster than steam and so, has the potential to raise the overall rate of revenue growth, although this could have a dilutive impact on the overall group margin.

Peristaltic pumps – this is a division of 10 separate businesses that create pumps and fluid management systems for, primarily, the biotechnology, food & beverage, chemical

and environmental sectors. A peristaltic pump is a closed, rotary roller pump system that forces fluids through (usually flexible) pipework and in so doing means that the materials being pumped do not come into contact with the pump mechanism. This allows the pumped materials, for example blood, to remain sterile. Products range from small diameter, ultra clean medical or biotechnology delivery systems right through to industrial scale pumps carrying fine or abrasive materials that would clog or degrade a centrifugal or impeller pump. This division also manufactures sinusoidal pumps which provide slow, gentle motion through pipework for more delicate materials such as foodstuffs. In addition to pumps, Spirax also provides replacement pipework (very common in medical applications) along with metering and flow control mechanisms.

This is the most profitable part of the group, delivering operating margins of over 35 per cent and is the fastest growing, delivering an organic sales increase in 2021 of 32 per cent. That strength was largely due to expansion in the biotechnology space (growing at c.30 per cent) and that positive trend continued into the current year when H1 revenues were up by more than one quarter. This has been helped by high levels of vaccine development and production on the back of Covid, a spike in demand that will begin to tail off in due course. However, there is likely to be some compensation as the group drives to grow more aggressively in Asia Pacific, a market in which it remains materially underweight relative to its other operating territories.

Pumps are the group's jewel in the crown and in any sum-of-the-parts would command a high valuation.

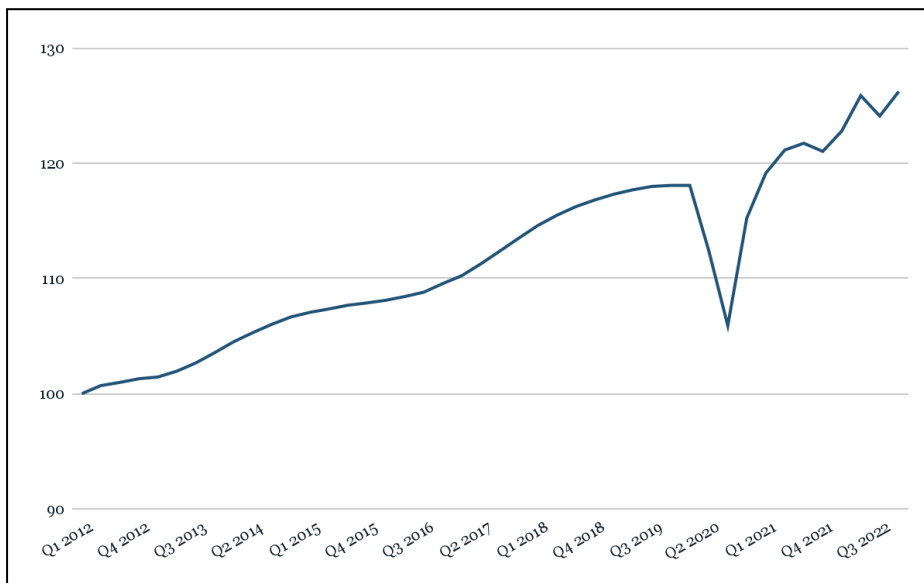
Macro drivers

Having so diverse a business footprint it is difficult to have any significant granularity on the forces propelling the business so the only meaningful set of data that investors should watch to assess future potential is Global Industrial Production (GIP). While the world faces increasing headwinds in many areas, core industrial processes are likely to remain largely intact while larger capital projects face cutbacks or deferrals. As noted earlier, such large scale investment programmes account for less than one sixth of the group's revenues so even as forecasts for industrial production have been reined in, it is likely that Spirax will continue its long term trend of outperforming this global yardstick.

Global Industrial Production (GIP) forecasts (source: Oxford Economics) have been reducing, but there is still forecast to be 3.5 per cent growth globally in 2022 (down from a forecast of 5.0 per cent a year ago and 4.5 per cent just before the outbreak of the war in Ukraine) with momentum still looking positive. Today, GIP is already well ahead of the pre-Covid levels in Q4 2019 with Q4 this year forecast to be about 8 per cent higher than immediate pre-pandemic levels. It is notable how fast this indicator recovered after

production fell by around 10 per cent in the immediate aftermath of the Covid outbreak and lockdowns. Global activity levels actually moved back past Q4 2019 levels even before the end of 2020 and grew 7.5 per cent in 2021, despite ongoing plant closures and disruptions.

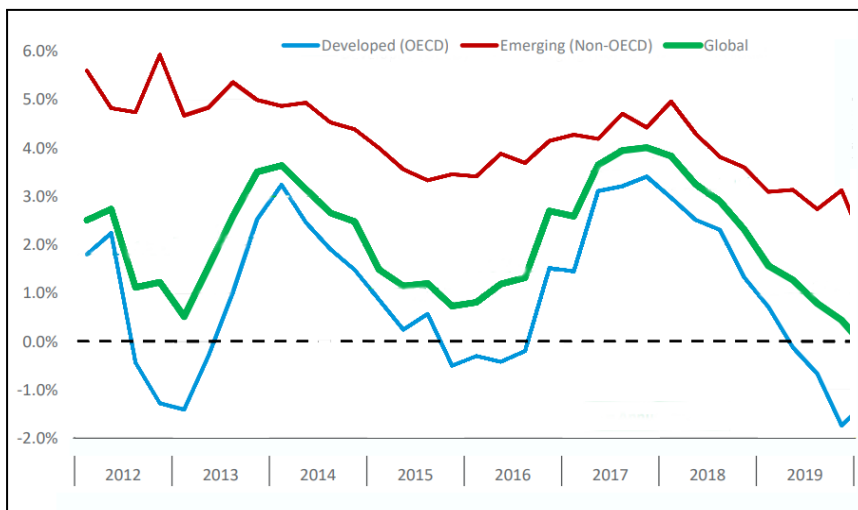
Global industrial production: Q1 2012 = index 100



Source: Spirax Sarco, Oxford Economic

Through the last 10 years the global rate of growth shown above has been an amalgam of two very different trends – strong emerging markets and more sluggish mature ones. Spirax is generally less well represented in the former, especially in Asia, which makes the performance it has been able to deliver all the more impressive.

Growth rates in mature and emerging markets pre-Covid



Source: Spirax Sarco

In 2021, Spirax's revenue grew overall by 17 per cent on an organic basis (well ahead of GIP growth) with 9 per cent in steam, 7 per cent in ETS and 32 per cent in pumps. This continued a well-established pattern of delivery revenue growth ahead of the changes in the key yardstick.

Direct sales model

Another key strength is that Spirax uses a direct to customer sales model across all of its businesses. This gives it better control of what, how and where its products get into the market: around 80 per cent of revenue is generated directly from the 2,000 sales and engineering staff. This provides a higher service level, enables customers to build more integrated solutions (known as applied engineering), it better defends pricing and helps to drive product innovation and development. The remainder is sold through third-party distributors and is focused more on customers' basic spares, consumables and repairs requirements, an inherently lower margin business.

Outlook

The outlook for the global economy has become increasingly uncertain through 2022, but a skew towards industries that are likely to hold on to better rates of growth than the wider economy should prove helpful in sustaining growth here. Add in elimination of the problematic French business, continued scope for accretive acquisitions, a drive to increase its footprint in the faster growing emerging markets and continued ability to push its own cost inflation into product pricing and the outlook is still pretty positive. This is helped to no small extent by having its fastest growing division (pumps) generating the highest margins.

Forecasts have been edging up through 2022, despite the lowering of the forecast growth in the GIP with PBT (profit before tax) estimates for 2022, 2023 and 2024 all around 5-6 per cent higher than they were at the turn of the year. Given the extent of gyrations in the world since then, that is no mean feat. EPS estimates for 2022 are some 36 per cent higher than the actual reported figures for 2019, pre-Covid, while many other businesses are still straining to return their profits to pre-Covid levels.

Valuation and conclusions

Spirax certainly has most of the attributes required to classify it as a 'compounder' stock. Morgan Stanley defines a compounder as: "high quality franchise businesses, ideally with recurring revenues, built on dominant and durable intangible assets, which possess pricing power and low capital intensity".

Investors have enjoyed high returns from investing in this stock, and since the low point in the midst of the GFC in 2009 Spirax has given investors an average annual total return of just over 24 per cent. This is even after the material de-rating (the share price has fallen by more than one-third since its all-time high at the very end of 2021) that has taken place year to date. The reasons for the de-rating were: 1) the rating was simply too high relative to specific growth and industry outlook, with the year 1 PE hitting 50x at the peak; 2) the general rotation out of higher growth stocks from Q4 2021 onwards; 3) some rubbing off of the de-rating of technology stocks out of (now well-proven) concerns about rising interest rates as some valuations of this stock had been constructed using DCF (discounted cash flow) models; 4) a feeling of an excessive valuation spread between growth industrials and those more cyclical engineering stocks where single digit PE ratios were commonplace.

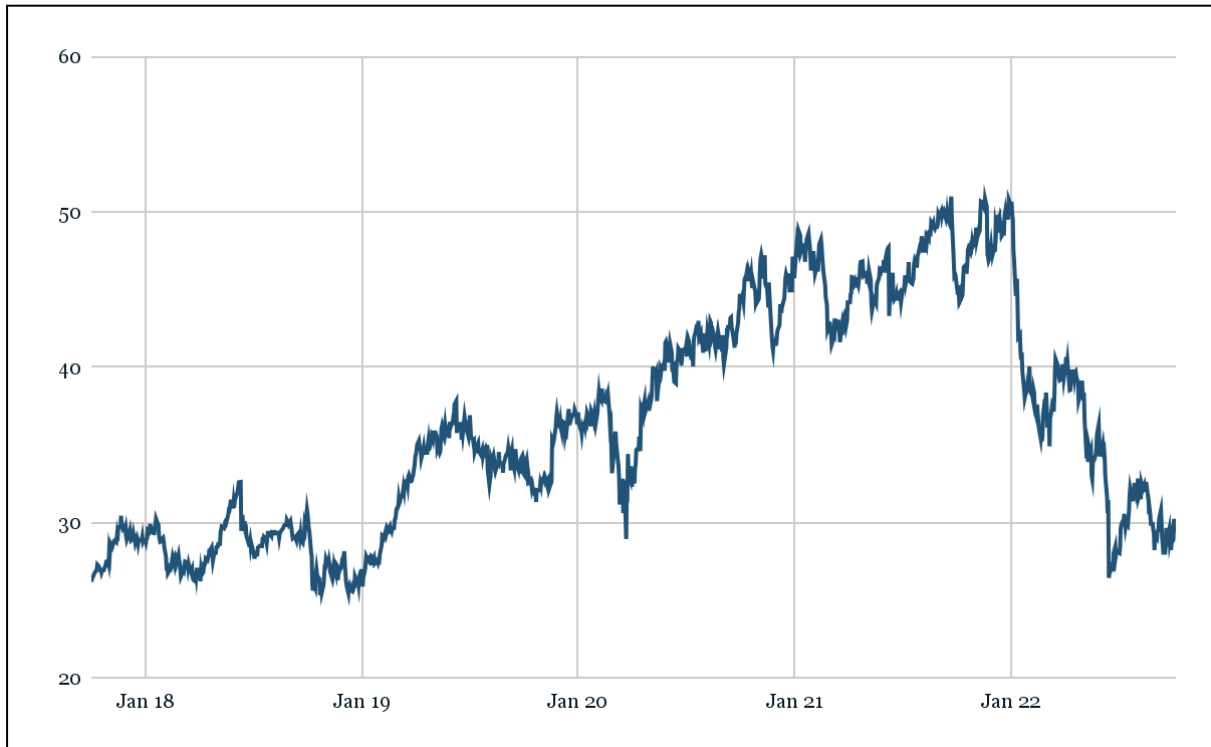
The PE rating has fallen to around 30x and while that may seem still to be expensive as many other sectors de-rate, that is something of a false perception. Cyclical stocks into a tougher economic climate look cheap on their apparent PE valuations, but in reality earnings are likely to fall sharply so an apparent PE of 7x easily becomes 20x as forecasts drop. Spirax's impressive record of resilience merits a premium but that premium needs to be set against the realistic valuations of peers and comparables, not the current ones, which are illusory. So, a PE of 50x was too high but 30x does not look demanding, although it does not look cheap.

While remaining confident of growth in profits, analysts are more cautious about the valuation. All but one of the forecasting analysts in the consensus rate this stock as a HOLD; the other one rates it as a SELL. This feels about right and is an unusually honest position from brokers who can all too easily remain on a positive tack just because this is seen as a high quality business. The de-rating should be over although in such a turbulent time one should never say never.

While it is hard to see what or where the catalyst is that might push up the share price, today's share price at around £104 is likely to prove an attractive long-term entry point. But that may still be the case in three or six months' time.

While this does look like a great business and arguably the pick of the bunch in the industrial space, there is no rush to buy it right now, but in five or 10 years you will want to have gotten involved.

Halma – stable genius or Mad Hatter's tea party?



Source: FactSet

Snapshot

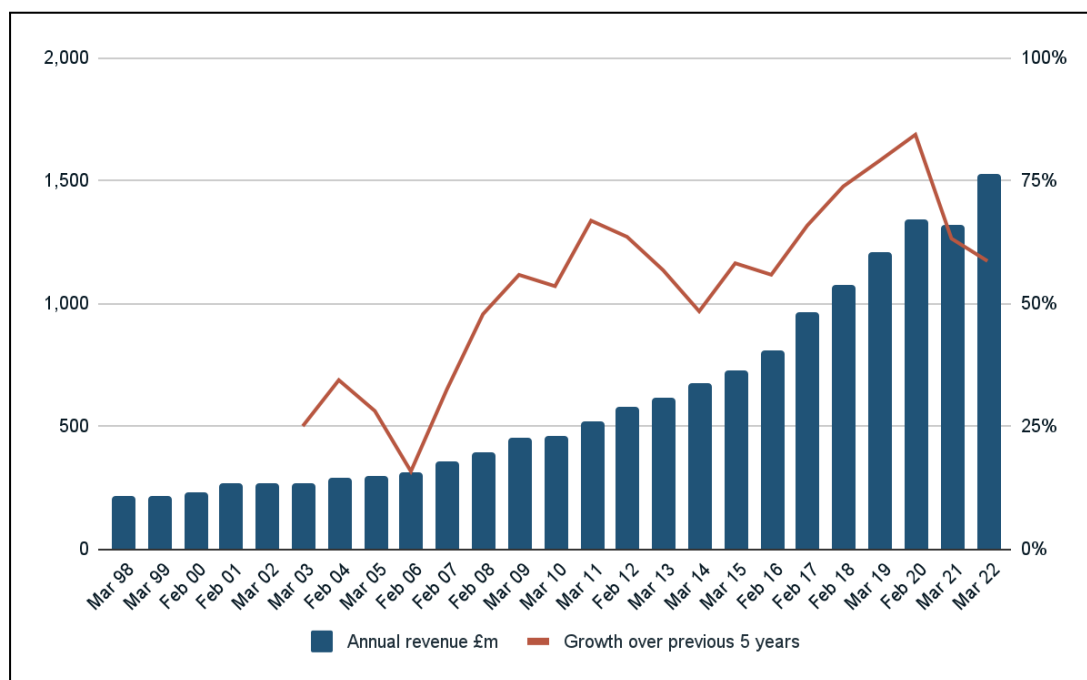
Halma is a FTSE100-listed industrials stock working typically in the field of advanced electronic instrument manufacturing selling products in the areas of industrial operational safety, environmental analysis and healthcare. These are all areas of long-term growth through market's structural change, human demography, emerging markets and tightening regulations. This business traded well through the pandemic with no hit to profits and barely an impact on revenues and in the last full year (to March 2022) reported earnings before interest, tax, depreciation and amortisation (Ebitda) was 13 per cent higher than in 2019, a key yardstick many businesses have yet to report. Even in 2021, Halma reported profits above pre-Covid levels.

This is an interesting business that feels like something more akin to an investment trust with the PLC board working as more of a portfolio manager that picks the new investments and allows operational management a great deal of autonomy in actually running their business.

The group owned and ran a portfolio of 50 discrete businesses at the last year-end, but this number had increased by 13 during the last financial year and has stepped up again since the period-end. This is a business hungry for growth and it has a stated ambition to try to double the scale of the business (in revenue terms) every five years. While there

was something of a hiatus in the years immediately after the GFC (understandably) that derailed this kind of ambition, there has been strong progress towards such a goal in the last five years. Had it not been for the small dip in revenues in 2020 and the economic hangover in 2021, this ambition might well have been achieved last year. The world's stiffening economic headwinds make it unlikely that this dream will be realised in the next three years but the five-yearly rate should be able to hover around the 50 per cent mark, based on the consensus estimates.

Revenues (lhs) and five-yearly growth rate (rhs)

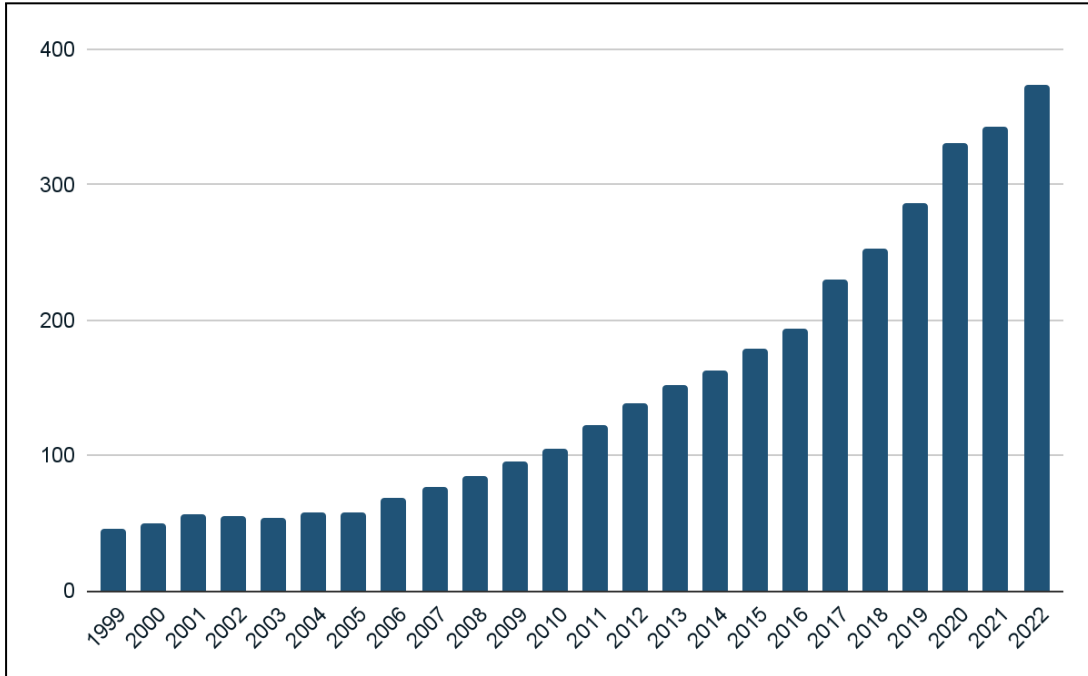


Source: FactSet

The aim is to grow the revenue base with a broadly equal blend of organic growth and newly acquired revenue. The target is to acquire around 10 new operations each year; there is no shortage of options and opportunity as Halma operates in hugely fragmented markets and is willing to cast its net fairly wide. Management reckons on running the slide rule over 600 to 700 potential targets every year. The businesses bought are usually of a moderate size with a maximum consideration for the 13 bought last year of £164mn (maximum consideration after earn outs): that is around £13mn a piece.

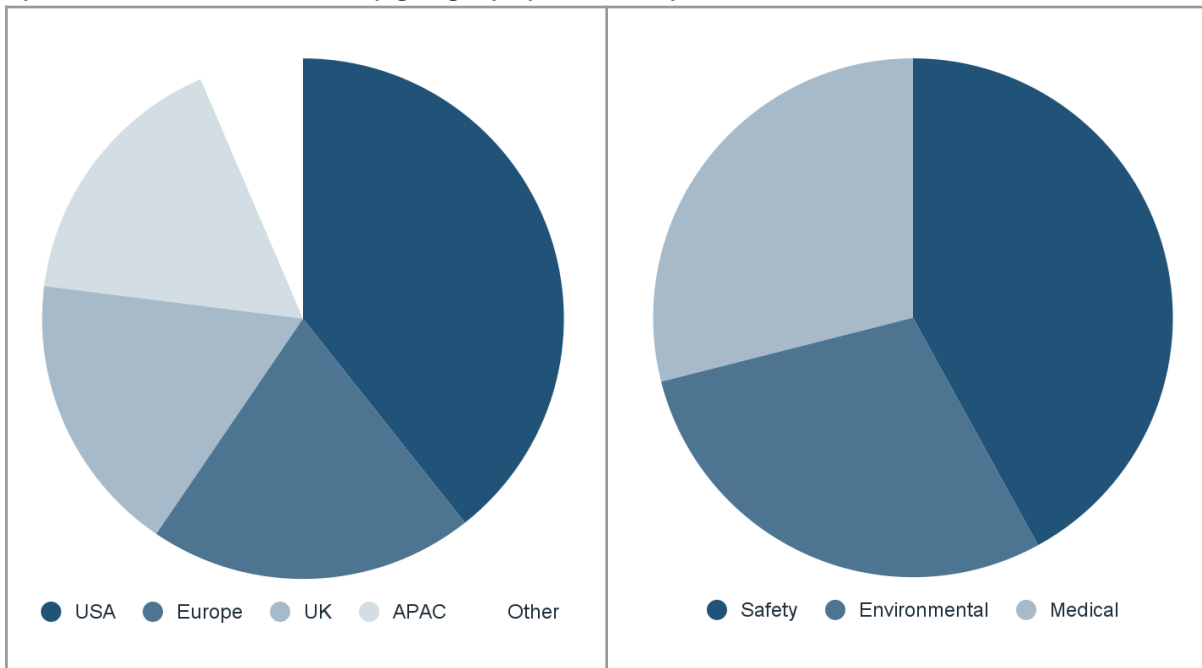
This is a business that is well balanced geographically, an essential facet if you are wanting to deliver a consistently high rate of growth, with offices in 20 countries and a good spread of revenue across five regions: USA, UK, Europe, APAC and RoW.

Long run Ebitda performance



Source: FactSet

Split of Halma's revenue: by geography and discipline



Source: Halma

Drivers

The main organic driver for Halma is the growing pressure on businesses and organisations (private and public sector) of increasingly small scale to ensure both internally and externally that the products and services they provide are safe, fit for

purpose and comply with all relevant regulations. This is achieved through the provision of testing and monitoring hardware and, increasingly, software to a vast and diverse array of end uses.

Demands on businesses and all service providers evolve constantly and require steady investment in new and different forms and formats of monitoring, analysis and reporting of their processes. That regulation is generally tightening in most markets as specifications on things like environmental standards increase. In many smaller economies and large ones that are evolving (especially China where health and safety standards in many areas still lag the rest of the world) there is still substantial structural growth taking place; while in more mature economies regulation does evolve, but is operating in more of a repair, replace and upgrade cycle.

So what precisely does Halma do? It operates three separate divisions: environmental & analysis, safety and healthcare.

Environmental and analysis

This business area covers hardware and software for monitoring and analysis of the environment. The group's products and services operate in these fields:

- **Environmental monitoring** – precise measurement of gases and liquids in medical and scientific applications and underwater equipment monitoring
- **Gas detection** – personal and installed monitors for flammable and toxic gases
- **Optical analysis** – optoelectronic equipment, light measurement solutions and electromagnetic analysis
- **Water analysis & treatment** – flow controls, pipework management, leak controls and water purity measurement & analysis

Safety

In this division sit businesses that deliver technologies that keep people safe, protect core infrastructure and allow for the safe movement of people and traffic. It also provides technologies that protect people and assets in the workplace in the industrial and logistics sectors. Historically, this branch of the group was split into and reported as two parts: Infrastructure and Process Safety. It now reports as one line and, after combining, some £60mn or 10 per cent of revenue moved into the Environmental & Analysis division.

This division, today, covers technologies in:

- **Elevator Safety** – sensors, displays and emergency services communications
- **Fire Detection** – smoke detectors, alarm zone panels, flame detection, gas detection and wireless monitoring
- **Fire Suppression** – detection and ‘flooding’ enclosed spaces with suppressive materials
- **People and vehicle flow** – automatic door systems and radar-based traffic monitoring
- **Pressure Management** – pressure and burst detection and alleviation in industrial pipework
- **Safe storage & transfer** – industrial pipework corrosion and erosion monitoring and alleviation plus valve controls
- **Industrial access control** – machinery safety locks & cages and ‘trapped key’ interlocks

Healthcare

Here Halma provides a wide range of equipment and devices for the measurement and assessment of patient health in primary care, emergency and surgical environments

- **Life sciences** – sub-assemblies for medical equipment and medical pumps (syringe piston and peristaltic pumps, the latter used also in non medical industries such as food and beverage)
- **Health assessment** – cardiac, ophthalmic, respiratory, pregnancy and blood monitoring and assessment devices plus diagnostic devices for general practitioners, hospitals, clinics and paramedics.
- **Therapeutic solutions** – oxygen delivery, surgical devices, bone repair systems and gas analysis

Outlook and recession proofing

The very long growth record from Halma is set to continue. As shown in the long-run Ebitda chart (above), growth this year would make 20 unbroken years of profit growth which is impressive given that this period encompasses both Covid and the GFC.

Consensus forecasts suggest that from Ebitda in the year to March 2022 of £373mn, Halma can deliver £417mn this year, £449mn next and £479mn in FY2024. The trading update for H1 made at the end of September indicated, albeit without the full knowledge of the unfolding interest rate and currency crisis, that it was still confident that it would be able to meet market expectations by March. To be honest, this might get tougher as H2 progresses but the starting expectation is still for growth to be achieved – this business has steered successfully through equally rough seas.

Valuation and conclusions

From the ending of the global financial crisis in 2009 to the start of 2022, Halma exhibited a staggering share price performance. The price rose more than 20 fold in 12 years while the FTSE All-Share Index a little more than doubled. On a TSR basis, investors enjoyed an annual return of just over 30 per cent. However, such a strong surge in the share price left the shares expensive: at the start of 2022 they were on an eye-watering year 1 PE ratio of 50.5x and as might be expected from a stock with such a growth rating, there was very little in terms of income – the prospective dividend yield was just 0.6 per cent.

The stock has, like Spirax, de-rated from that 50x high to just under 30x for similar reasons. Factors are the rotation out of high growth stocks, the rating misaligned with growth and peers and interest rate pressure where DCF is used for valuation. The new rating feels more reasonable for a business that is promising double-digit growth in the current, more testing environment.

While the numbers very much do the talking here it is important to note that while growth at Halma is good, it is not spectacular with an average expansion of around 10 per cent and in the forecasts for years two and three, this drops to nearer 7 per cent. Given the currency tailwinds and that typically around half of a year's growth come from new acquisitions, the core businesses of the group (those assembled in prior years) are likely only to be growing at a low to mid single-digit percentage rate.

Halma needs to keep making good acquisitions in order to keep up the momentum. It does have a good record in this regard and has shown that by buying smaller, private companies it has been able to pay earnings multiples that are much lower than would be possible bidding for larger, listed rivals.

Every year it seems to have enough choice of potential additions to be able to avoid buying poorer quality businesses. But as the business gets larger, then the acquisitions must get larger, too, in order to keep up the momentum: that or the number of deals has to expand. Given the prices paid for the two acquisitions so far this year (£150mn and £50mn versus an average £13mn in FY2022) the board looks to have gone down the path of upping its sights. This inevitably changes both the risk profile (all eggs in one basket) and must limit the options it has. While there are likely to be myriad £10mn targets, there are going to be far fewer £150mn ones.

This is a hugely diverse business and while its various operations are coalesced into three broad areas or disciplines (and there are common threads and common areas running through in detail what each of the businesses does), it is harder to see what the overall

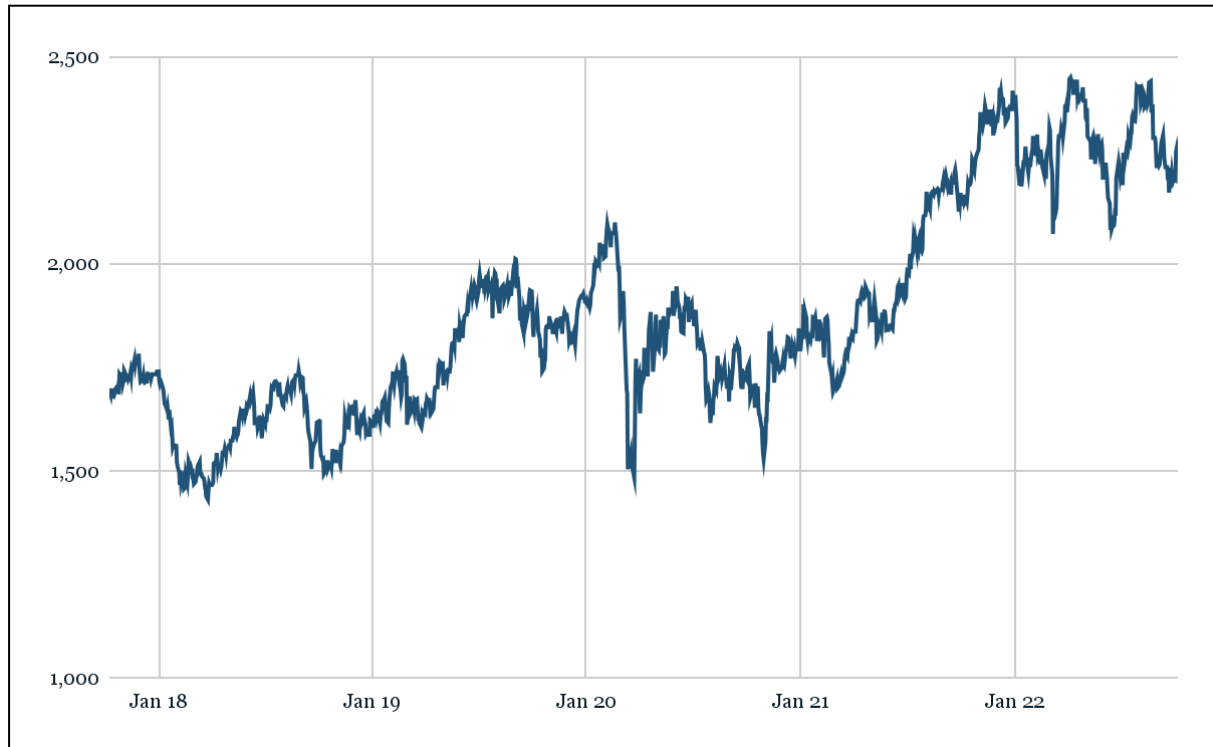
driver is. There are few yardsticks against which to measure or predict – just trust in management and the track record, which may become harder to trust as the long standing CEO steps down. Also running through the group portfolio, I did find often it hard to see the synergies, if indeed there are any, from added businesses.

Overall, what is driving trade specifically and exactly which of the numerous businesses owned are doing well is not clear to external observers and everything feels rather opaque. Plus this is a business in a state of constant flux and with so many new businesses being added to the portfolio, what one invests in today is likely to be very different from how things looked five years ago and how they will look in five years time. One has to just trust that management can and will continue to make the right picks for new additions and that is a somewhat blind process. It may be an old fashioned view but I would rather invest in a business where the moving parts and what will drive it is more visible and measurable externally.

Halma has an excellent record, but as the oldest mantra in investment says, the past does not guarantee the future. It is likely that Halma will be able to sustain a good growth rate but I would rather be invested in a business that is less opaque and where I would have at least some idea of what the portfolio would look like in a few years time. As with Spirax, it is hard to see what the immediate catalysts for an improving share price are and with analysts generally cautious in their stock calls (two buys, five hold and even two sells) it does feel as if the shares are likely to mark time at best and even if one is attracted by the profile and the record, there is likely to be no rush to buy.

Continued below...

RELX – leopard changes spots



Source: FactSet

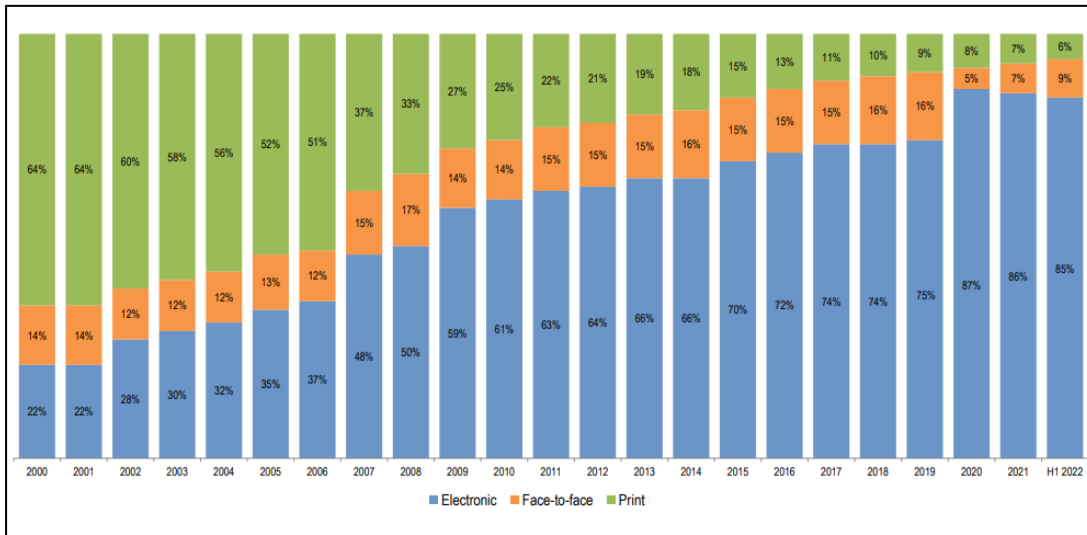
Snapshot

This is one of those stocks that may not be immediately obvious to investors, but is a major, multinational company (clients in 180 countries and offices in 40) that sits in the upper reaches to the FTSE100 index with a market capitalisation of around £43bn. This is the re-invented and re-branded Reed Elsevier, the erstwhile publisher and now digital information business that has been through a transformation not wholly dissimilar to that of Pearson (which we reviewed in a recent [Alpha article](#)).

Most physical print businesses have recently been closed (print now accounts for just 6 per cent of the revenue having been two-thirds of operations back in 2000), leaving the group strongly focused on digital data, data analysis and business decision-making/modelling tools and services. The group profiles itself as a provider of information-based analytics and decision making tools for professional customers – in practice that means it collates, publishes and archives articles, data, forecasts and analysis (from a range of in-house writers/analysts, independent submitting contributors, academic institutions, industry bodies and government departments). This data is accessed by thousands of commercial and public bodies to prepare reports, design & execute projects accessing libraries on either a subscription (the preferred route as it gives high income visibility) or ad-hoc, pay-as-you-go purchases.

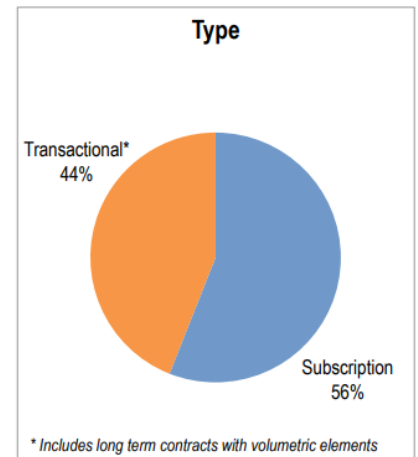
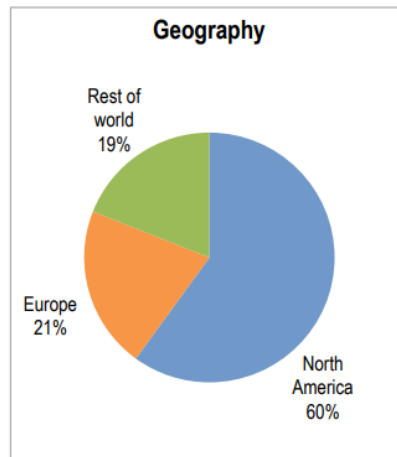
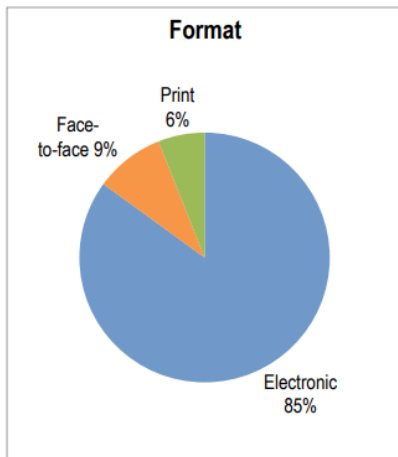
In addition to data provision, RELX is a leading exhibition, seminar and trade show organiser – in the chart below is this 'face-to-face' element of the group's revenues.

RELX's transition from print to digital – split of revenue



Source: RELX

Revenue breakdown: format, location and payment profile



Source: RELX

Operations

RELX is split into four operational divisions – STM, Risk, Legal and Exhibitions: aside from exhibitions, all of these disciplines operate in broadly the same manner, selling owned information and IP but with some offering more sophisticated tools with which to extract value from the data (higher margin) while others simply sell access to raw data.

Scientific, technical & medical (STM) – this is the largest division (just) with revenue in the last financial year of £2.65bn and EBIT of £1bn. A global footprint and the No.1

market position (18 per cent by count of articles stored), this arm of the group provides information and data analytics for institutions and professionals to help advanced skills, services and products in a range of more technical disciplines. The bulk of the revenue comes from access to proprietary databases (19 million archived articles with 600,000 added annually - close to 2 million other submitted articles are rejected each year) and targeted academic research with around three quarters of revenues flowing from the more predictable subscription channel. This division retains the largest physical print presence with 11 per cent of sales still in this more traditional format.

RELX is seen as 'punching above its weight' as against its 18 per cent raw market share on article count, its source materials are cited more heavily in 'heavyweight' journals, papers and third party research according to the Field-Weighted Citation Impact as published by Scopus (note however, that Scopus is a RELX subsidiary).

This is a business block with relatively low growth, essentially tracking long-term global GDP averaging just 2 per cent since 2015. It is notable that the rate of expansion in the size of the data archive has outstripped the 7.5 per cent compound annual growth rate (CAGR) in revenue over the last five years. This potentially indicates price erosion. However, revenue growth has accelerated a little in the last year reflecting a faster shift to electronic access and greater subscription numbers.

Risk – fractionally smaller than STM in revenue terms, here RELX provides customers with analytics and tools for informed decision making with proprietary algorithms to evaluate and predict risk arising from those decisions. Revenues are just under £2.5bn and last year's EBIT was £915mn. The bulk of the data provided relates to general financial (personal and corporate) and insurance risk with much smaller specialisms in a tight range of industry specifics (such as aviation) and tools for governments to eliminate fraud, especially in benefit schemes. The majority part of the business (under the Business Services banner) deals with fraud and identity verification.

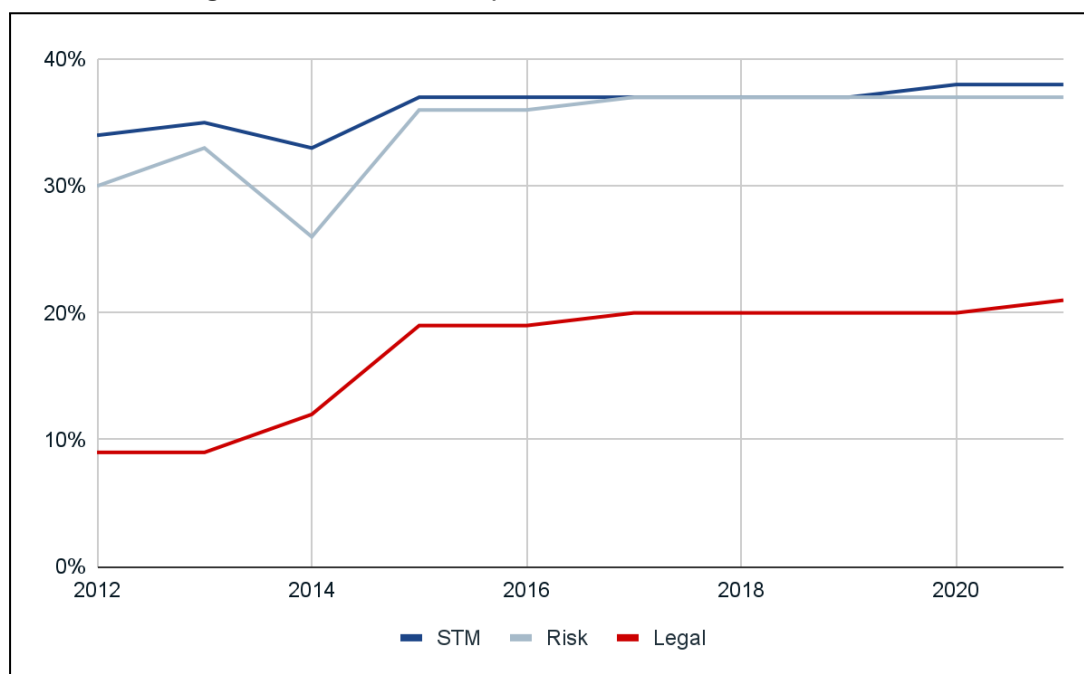
This channel has no remaining print output and is 99 per cent electronic (the remainder is face-to-face contact), but the bulk of access is still on an ad-hoc basis with less than 40 per cent of users on subscriptions. Growth is faster than in STM, but that growth is largely driven by new additions and acquisitions which drive a little over half the annual revenue expansion of around 7 per cent. Older data sets track a similar path to STM with growth more in line with long-term GDP. This is perhaps surprising, given the much more rapid expansion of the ID verification industry (which industry research suggests is set to grow at over 16 per cent CAGR through to 2030).

Legal – in this segment RELX provides legal, regulatory & business information and analytics for legal professionals. There is £1.5bn of sales with lower margins than the previous two segments but still above 20 per cent at the EBIT level. Margins had been expanding but look now to have found a level.

This is another area of lower growth, and is arguably sub-GDP expansion rates, often barely reaching 2 per cent across the last five years. There has been a sharper decline in printed material and basic reference (the bulk of the services here) has little growth potential while the faster expanding analytical tools operations look to be cannibalising revenues from within the division. In the latter area, there is crossover with the Risk division and increasingly law firms appear to be using data analysis and algorithms to devise case and advice strategies – a swing towards RoboLaw if you like.

This business is predominantly in the US, still probably the most litigious nation, and where in the court system at least a well devised case strategy is crucially important. This suggests the division might have a brighter future than its rather lacklustre recent past.

Divisional margins over the last 10 years



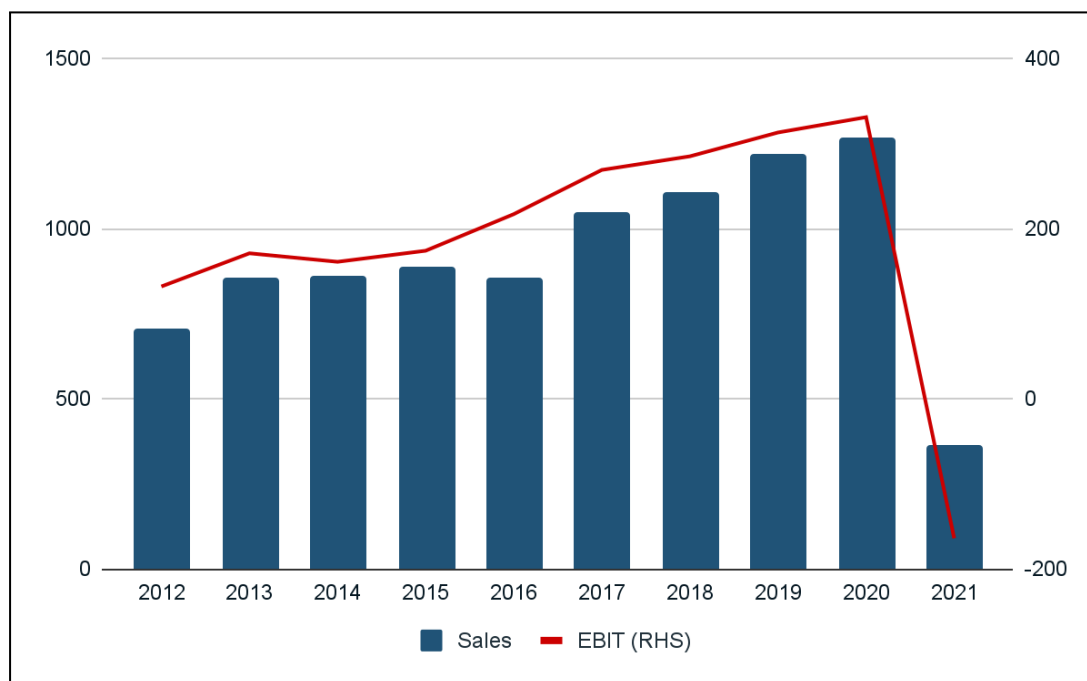
Source: FactSet

Exhibitions – this is precisely what one imagines with trade and other face-to-face and, increasingly, online gatherings that allow customers and stakeholders to meet, discuss and purchase goods and services. Under the Reed Exhibitions banner, the group has the operating rights to around 400 exhibitions globally, making it the world's second largest operator behind Informa Markets.

When the world was functioning normally, this would mean around 100,000 exhibitors renting stand space each year and the events welcoming 5mn to 6mn visitors/delegates, who are sometimes (but not always) another source of revenue.

Understandably, this area was hit very hard during Covid. This had been a pretty robust performer with annual sales growth of 6-7 per cent, and although margins were somewhat erratic they had stabilised in the mid-20s per cent. In 2020 revenue dropped by 70 per cent and the division made substantial losses before making a sizable (but not far from complete) rebound in 2021. As the world has begun to normalise, revenues in H1 2022 tripled but were still only 60 per cent of the levels seen in 2018 and 2019; and profits are just one quarter of the levels achieved in those trading periods.

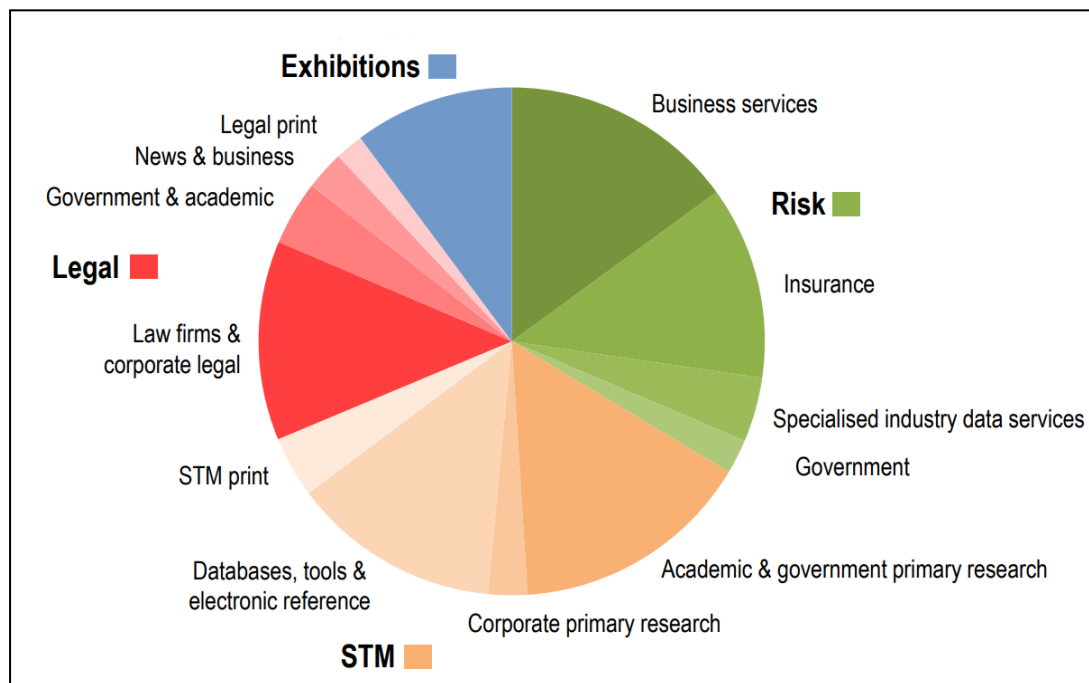
Trading record for the Exhibitions division – £mn



Source: FactSet

So, on an annualised basis, there is around £700mn of revenue and £250mn-£300mn of profit lost from this division that could still come back into the mix. That is not quite likely to be the case. Industry forecasts suggest, and most likely are based on a bullish outlook of future Covid disruption, that global exhibition revenues in 2025 will still be below 2019 levels by around 3 per cent. However, this division should still be capable of injecting a meaningful contribution to overall growth (probably around 6-7 per cent PBT growth on its own) for the group. That rebound could also have a positive impact on the rating for the group as this stream of earnings, even though depressed, can be accorded the 'recovery' tag and consequently a higher valuation.

Relative size of all disciplines by 2022 pro-forma revenue



Source: RELX

Outlook and forecasts

Analysts are generally bullish on numbers for RELX and estimate growth in pre-tax profits in FY 2022 of around 35 per cent; growth at the half-year stage was lower than this at 21 per cent so an accelerating trend is predicted. The reason for expecting a much faster rate of growth in H2 will be improvement in the exhibitions space and a marked increase in currency tailwinds – in 2021 the average US dollar rate was around 1.36 and this year will likely be below 1.20: around 60-65 per cent of profits come from US markets. Exhibitions made only £10mn of EBIT in FY 2021 and £60mn was earned in H1 alone (and note that pre-Covid profits were over £300mn).

Growth expectations slow into 2023 (at 11 per cent for PBT) and 2024 (8 per cent improvement) at the headline level but, backing out likely further currency tailwinds and further profit rebound in exhibitions, the core like-for-like growth will probably only be in the low-to-mid single digit percentage range.

There is some scope for additional momentum to be injected, however. Acquisitions have been depressed with 2021 only seeing around half the normal spending level (long run average is £500mn per annum) on organic development (the target is 5 per cent of revenues). This could jump up by as much as £100mn and with net debt / Ebitda below recent levels, share buybacks are once again on the agenda as a way to return cash to

shareholders (a £500mn programme was recently announced, although this is below typical levels pre-Covid).

So, while growth in many parts of the core business is relatively low on a like-for-like basis, this should not really hold back EPS growth. And while growth rates are relatively low, the group's earnings streams are defensive and the activities that lean on the group's datasets and tools are likely to be less affected by economic slowdown. Indeed, when money is tighter many businesses and most government departments will be looking harder at risk assessment and generally looking to find ways in which to allow the investments they do make to deliver the best value. Take the very recent promise by prime minister Liz Truss not to cut public spending but to "make sure we spend public money well" – that is easier said than done and can really only be achieved with a lot of extra analysis and modelling using the sorts of libraries that RELX owns.

Conclusions

The reinvention of Reed Elisiver becoming RELX, the switch from print dominance to digital and the solidly defensive nature of most of the services it offers has transformed this business and allowed a substantial re-rating. Ten years ago, the stock barely attracted a market average rating but today it stands at a material premium, a premium that has widened as the transformation has evolved.

Over those same 10 years, the average TSR has been almost 17 per cent per annum, but can that continue? There is little left now to change and we need to reflect on the generally low rates of underlying revenue growth that the divisions have been showing, especially the two largest business blocks where growth struggles to exceed background GDP expansion.

Everything is okay in terms of overall growth, but little more than that: low single-digit revenue growth, mid single-digit profit growth at the core and the stronger appearance to the reported profits has too much to do with 1) currencies and 2) the bounce back from the black hole that collapsing exhibition activity tore into the group's fabric.

This is a solid business, with decent prospects but that is not really enough to propel the share price. Analysts are split on this stock with five buys and five holds and split along the same lines are the bullish and more cautious forecasts. The profit estimates we refer to above are averages of a wide spread of 15 per cent between highest and lowest which makes it harder to see whether this stock is fully valued or may have some small amount of upside left in it.

In the current economic climate it is wiser to err on the side of caution and while we can be pretty confident that this stock is not over-valued, neither is it looking an obvious buy at this level. If you want to buy a data provision business **Thomson Reuters (TRI-CA)** looks more interesting, looks set to grow faster (without the same measure of help from currencies – it is listed in Canada) and analysts are both more positive and see generally more upside in the share price; if playing the rebound dynamics on the exhibitions sector then there looks to be better value in **Informa (INF)**.

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