

AlphaScreens: the quest for quality

1 February 2021

Aim stocks lead the way in this month's screen

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:

- Aim stocks are once again scoring the best against our Alpha quality screen rules, with 37 companies passing at least 7/9 tests of which seven companies scored 9/9.
- Leading lights include **Boohoo Group (BOO)**, which has made some decent efforts to consolidate its position with acquisitions and further investment in its website. It seems that, with the shares up by over a quarter in three months, the market has forgiven it after last year's controversy over supplier factory conditions.
- This month's magnificent seven also includes **SDI Group (SDI)**, a company which manufactures niche scientific and technology products; **Cerillion (CER)**, a software solutions business; **RWS Holdings (RWS)**, which provides intellectual property support services; **Renew Holdings (RNWH)**, the engineering contractor; and **Cohort (CHRT)**, the digital specialist for defence industries.
- Miner **Pan African Resources (PAF)** completes our Aim quality top set. Precious metals have been in the headlines this week and mining companies (which pay dividends, too) are a good exposure for investors with a longer horizon and who aren't just speculating on underlying prices of assets like gold and silver.

The dream company

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

Unfortunately, this kind of dream company is extremely rare and stock screens are too crude to provide the depth of analysis needed to provide confidence that a business may be the real deal. In particular, it is inevitable that some of the shares highlighted by our Alpha Quality screen will be cyclical companies that are enjoying a good run rather than companies that are well placed to sustain high returns through many business cycles to come. What our screen does do, however, is attempt to find pointers for companies that may have the potential to go some way to filling the dream brief. What's more, buying shares in companies that look attractive based on quality metrics can often prove a profitable strategy, even if many of the shares picked fall short of the buy-and-hold ideal.

Alpha Quality screening criteria

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

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

avoid companies with very aggressively 'geared' balance sheets. Focusing on operating margins also provides an assessment of quality at the operating level – i.e. before the impact of debt.

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

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

Not many stocks pass such a stringent list of criteria. The ones that pass all the tests are listed at the top of the table, followed by those failing one test, then those failing two tests as detailed in the 'Tests passed' column. All stocks must pass the test for three-year, higher-than-average RoE and margin to feature in the table. While the primary ranking of the stocks is based on the number of tests they pass, inside each of these groupings stocks are ordered according to their attractiveness based on operating margin and three-month share price momentum.

Alpha Quality screen: large-cap results

Name	TIDM	Market cap	Price	PE	Fwd NTM DY	grth FY+1	Fwd EPS grth FY+2	Fwd EPS momentum	3-month debt(-)	Net cash/ Cur	Tests passed (out of 9)	Test failed
QinetiQ	QQ	£1,730m	301p	14	2.2%	2.4%	5.0%	26.1%	-143m	GBP	8	/RoE grth/
Diploma	DPLM	£2,887m	2,318p	30	1.3%	34.4%	9.6%	4.9%	-173m	GBP	8	/RoE grth/
Games Workshop	GAW	£3,385m	10,330p	28	1.4%	58.3%	8.0%	-2.3%	-51m	GBP	8	/RoE grth/
Polymetal International	POLY	£7,459m	1,581p	8	4.1%	67.8%	18.2%	-5.0%	1,398m	USD	8	/Marg grth/
Unilever	ULVR	£111,480m	4,240p	19	3.4%	2.4%	2.1%	-5.0%	20,770m	EUR	8	/Marg grth/
Experian	EXPN	£23,446m	2,556p	31	1.4%	21.8%	13.8%	-10.3%	3,222m	USD	8	/RoE grth/
Britvic	BVIC	£1,989m	745p	14	2.9%	14.9%	15.3%	1.1%	635m	GBP	8	/RoE grth/
Evraz	EVR	£7,305m	501p	7	9.2%	169.9%	65.7%	39.0%	2,984m	USD	7	/RoE grth/Marg grth/
Rio Tinto	RIO	£69,689m	5,589p	8	5.3%	8.2%	26.4%	29.0%	6,352m	USD	7	/RoE grth/Marg grth/
Victrex	VCT	£2,033m	2,344p	28	2.0%	7.2%	13.7%	28.1%	-66m	GBP	7	/RoE grth/Marg grth/
Crest Nicholson	CRST	£831m	323p	12	10.2%	63.6%	38.1%	47.0%	100m	GBP	7	/RoE grth/Marg grth/
PayPoint	PAY	£427m	622p	12	5.0%	-32.3%	17.0%	23.4%	-21m	GBP	7	/PEG/Fwd EPS grth/
XP Power	XPP	£986m	5,020p	27	0.8%	20.7%	3.7%	26.8%	41m	GBP	7	/RoE grth/Marg grth/
Diageo	DGE	£68,990m	2,949p	24	2.4%	3.2%	12.0%	18.0%	12,430m	GBP	7	/PEG/RoE grth/
Imperial Brands	IMB	£13,912m	1,470p	6	9.4%	-1.7%	2.3%	19.8%	10,325m	GBP	7	/PEG/Fwd EPS grth/
Berkeley	BKG	£5,202m	4,189p	12	4.9%	5.5%	5.4%	4.1%	-951m	GBP	7	/RoE grth/Marg grth/
Kainos	KNOS	£1,526m	1,244p	34	0.5%	122.8%	-2.0%	2.3%	-59m	GBP	7	/RoE grth/Fwd EPS grth/
HomeServe	HSV	£3,508m	1,044p	22	2.3%	5.2%	14.3%	-5.9%	587m	GBP	7	/PEG/RoE grth/

Source: FactSet, 1 February 2021

Alpha Quality screen: small-cap results

Name	TIDM	Market cap	Price	PE	Fwd NTM DY	grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/ debt(-)	Cur	Tests passed (out of 9)	Test failed
Treatt	TET	£547m	918p	37	0.7%	35.1%	11.0%	43.4%	0m	GBP	7	/RoE grth/FCF/
PayPoint	PAY	£427m	622p	12	5.0%	-32.3%	17.0%	23.4%	-21m	GBP	7	/PEG/Fwd EPS grth/

Source: FactSet, 1 February 2021

Alpha Quality screen: Aim results

Name	TIDM	Market cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-)	Cur	Tests passed (out of 9)	Test failed
SDI	SDI	£113m	115p	24	0.0%	81.6%	2.3%	62.4%	3m	GBP	9	na
Cerillion	CER	£119m	402p	24	14%	25.2%	20.1%	36.3%	-2m	GBP	9	na
Pan African Resources	PAF	£436m	23p	5	3.0%	136.7%	8.2%	16.2%	53m	USD	9	na
boohoo	BOO	£4,274m	339p	32	0.0%	47.8%	25.7%	26.8%	-331m	GBP	9	na
Renew	RNWH	£412m	524p	12	1.6%	5.0%	7.6%	20.5%	15m	GBP	9	na
RWS	RWS	£2,287m	588p	24	1.5%	16.4%	15.4%	5.4%	38m	GBP	9	na
Cohort	CHRT	£254m	619p	9	1.7%	78.7%	6.4%	3.7%	13m	GBP	9	na
Sylvania Platinum	SLP	£278m	102p	4	1.6%	162.6%	0.0%	56.9%	-45m	USD	8	/PE/
MTI Wireless Edge	MWE	£70m	79p	24	1.7%	8.5%	17.2%	70.7%	-6m	USD	8	/Marg grth/
Watkin Jones	WJG	£502m	196p	12	3.8%	9.0%	11.9%	50.2%	40m	GBP	8	/RoE grth/
Tracsis	TRCS	£190m	650p	21	0.3%	10.3%	33.3%	26.2%	-16m	GBP	8	/RoE grth/
Frontier Developments	FDEV	£1,240m	3,155p	47	0.0%	16.3%	68.2%	21.3%	-22m	GBP	8	/PEG/
Tristel	TSTL	£275m	591p	41	1.0%	7.3%	13.6%	20.6%	0m	GBP	8	/PEG/
Alpha Fin. Mkts Consulting	AFM	£272m	255p	17	0.8%	0.5%	10.8%	18.6%	-30m	GBP	8	/PEG/
Trans-Siberian Gold	TSG	£123m	112p	6	7.1%	127.9%	15.0%	16.7%	7m	USD	8	/Marg grth/
CareTech	CTH	£552m	488p	10	2.6%	12.7%	12.0%	7.0%	353m	GBP	8	/Int Cov/
Caledonia Mining	CMCL	£133m	1,105p	4	2.6%	12.9%	81.0%	-14.3%	-16m	USD	8	/Marg grth/
Dewhurst	DWHT	£89m	1,600p	-	0.8%	-	-	64.1%	-15m	GBP	7	/PEG/Fwd EPS grth/
ULS Technology	ULS	£58m	90p	21	0.0%	-62.7%	172.2%	70.8%	3m	GBP	7	/PEG/Fwd EPS grth/
iEnergizer	IBPO	£599m	315p	22	4.5%	-13.4%	-1.7%	30.7%	-16m	USD	7	/PEG/Fwd EPS grth/
SigmaRoc	SRC	£180m	65p	15	0.0%	2.0%	13.7%	44.0%	47m	GBP	7	/PEG/Marg grth/
IMImobile	IMO	£487m	590p	36	0.0%	-10.7%	20.8%	50.3%	0m	GBP	7	/PEG/Fwd EPS grth/
Dewhurst Class A	DWHA	£89m	750p	-	1.7%	-	-	29.9%	-15m	GBP	7	/PEG/Fwd EPS grth/
Begbies Traynor	BEG	£147m	115p	14	2.5%	8.8%	39.1%	32.5%	7m	GBP	7	/RoE grth/PE/
Alumasc Group	ALU	£47m	131p	6	1.5%	15.12%	8.7%	34.4%	10m	GBP	7	/RoE grth/Marg grth/
Gooch & Housego	GHH	£341m	1,363p	35	0.8%	20.9%	16.2%	32.3%	15m	GBP	7	/RoE grth/Marg grth/
Volex	VLX	£492m	323p	20	1.0%	-2.5%	24.8%	30.2%	-16m	USD	7	/PEG/Fwd EPS grth/
Mattioli Woods	MTW	£209m	745p	17	2.7%	-15.9%	16.5%	13.7%	-23m	GBP	7	/PEG/Fwd EPS grth/
Oxford Metrics	OMG	£114m	91p	38	2.0%	58.7%	55.0%	21.5%	-13m	GBP	7	/RoE grth/Marg grth/
YouGov	YOU	£1,133m	1,025p	49	0.5%	9.2%	20.9%	6.2%	-26m	GBP	7	/PEG/RoE grth/
EKF Diagnostics	EKF	£312m	69p	34	0.0%	201.2%	-43.6%	-2.1%	-15m	GBP	7	/Marg grth/Fwd EPS grth/
Solid State	SOLI	£54m	630p	15	2.0%	-8.6%	-	7.7%	-2m	GBP	7	/PEG/Fwd EPS grth/
Gamma Communications	GAMA	£1,531m	1,605p	29	0.7%	23.7%	9.8%	-5.6%	-25m	GBP	7	/RoE grth/Marg grth/
Eckoh	ECK	£161m	64p	34	0.0%	-9.6%	23.1%	-2.3%	-12m	GBP	7	/PEG/Fwd EPS grth/
Venture Life	VLG	£111m	88p	25	0.0%	96.7%	-10.8%	-5.2%	2m	GBP	7	/Marg grth/Fwd EPS grth/
Crimson Tide	TIDE	£16m	3p	31	0.0%	25.0%	0.0%	-5.6%	-1m	GBP	7	/RoE grth/Marg grth/
Water Intelligence	WATR	£77m	501p	37	0.0%	42.3%	6.4%	-3.7%	-1m	USD	7	/RoE grth/Marg grth/

Source: FactSet, 1 February 2021

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