

## AlphaScreens: the quest for quality

17 May 2021

### Seven quality Aim shares

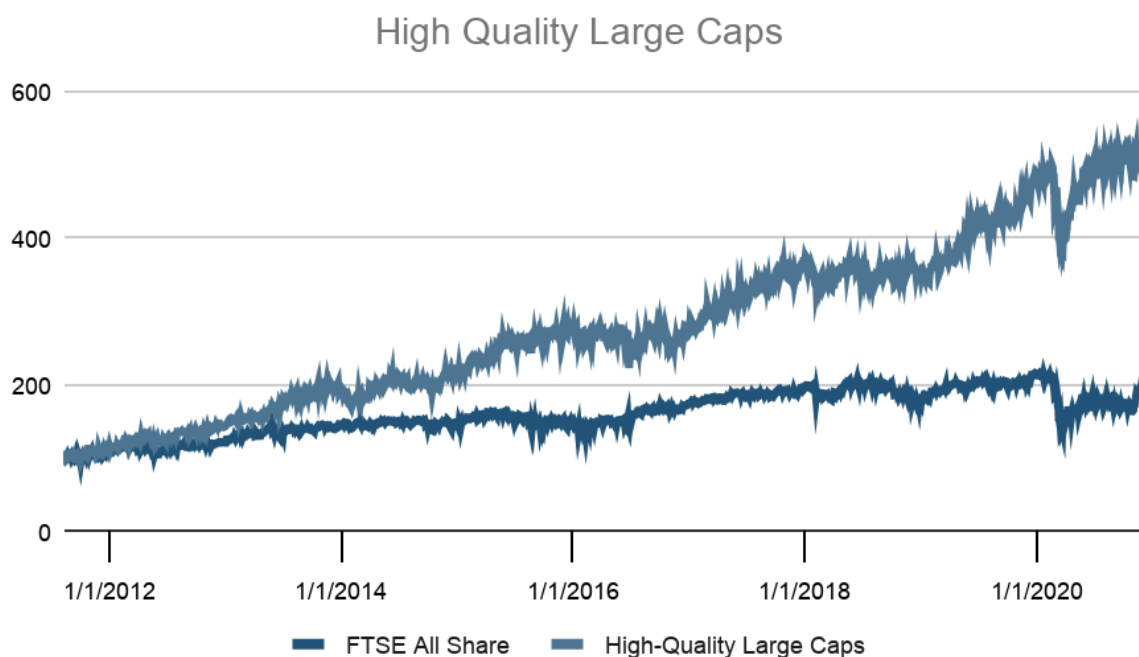
*The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on capital and sustaining it while reinvesting profits. This screen looks for shares that display these quality characteristics and can potentially deliver significant compounded returns over time*

#### Comment by Alpha editor:

- As the economy recovers from lockdowns, our quality shares screens are flagging numerous companies. On the Aim market, seven companies pass all nine of our tests.
- **Gamma Communications (GAMA)**, which provides cloud computer services, gets full marks, as does **EMIS Group (EMIS)** a healthcare software specialist.
- **Renew Holdings (RNWH)**, which operates as a contractor in engineering services and specialist building, scores 9/9 and it has enjoyed positive share price momentum in recent months.
- **RWS Holdings (RWS)** which provides niche intellectual property support services and legal services business **Keystone Law Group (KEYS)** also rank highly.
- Two other companies with perfect scores have seen their share prices fall back in the last three months. Miner **Pan African Resources (PAF)** and online fashion retailer **Boohoo Group (BOO)** are less expensive than they were, although long-term trends in their industries and their performance against our screen, suggest a positive outlook for these companies.

## The dream company

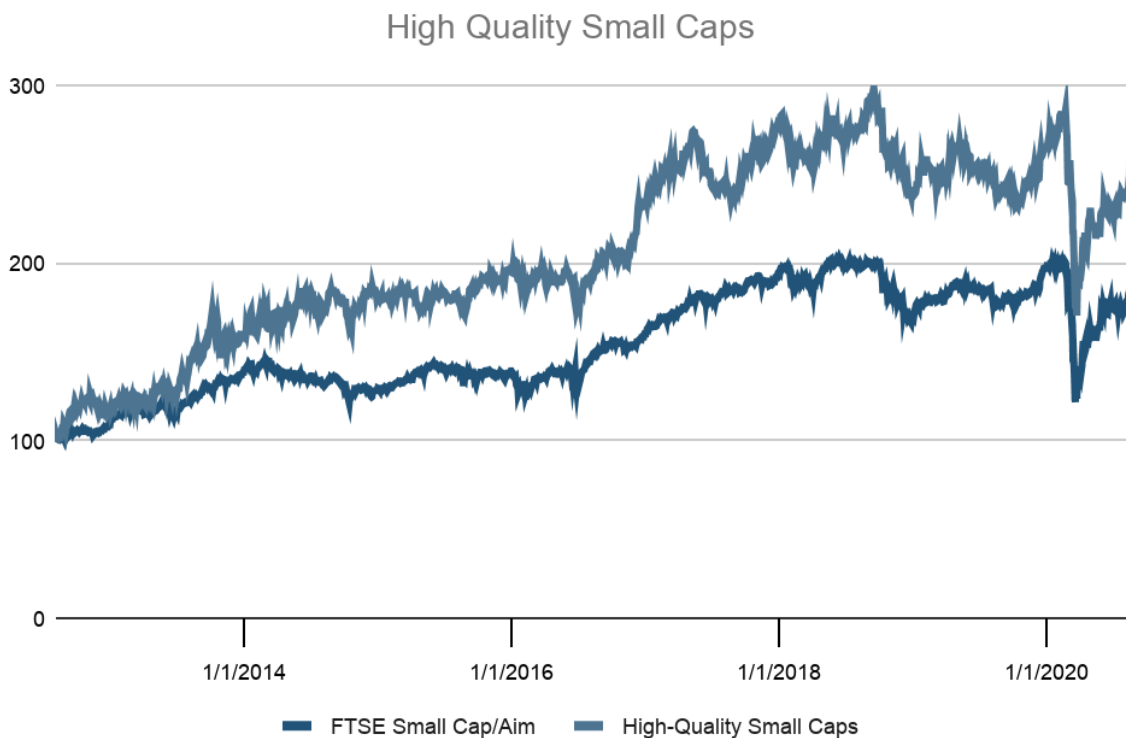
The holy grail for buy-and-hold investors is to find a business that is capable of generating high returns on its capital and is able to reinvest all its profits for decades to come, while maintaining those returns. The compound-ing effect of such an investment is what every long-term investor's dreams 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.



Source: Refinitiv, Investors' Chronicle

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.



Source: Refinitiv, Investors' Chronicle

## 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.

## Stock screen and methodology by Algy Hall

## Large-cap quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt 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
Polymetal International	POLY	£7,572m	1,599p	9	5.9%	0.6%	11.7%	-0.7%	1,012m	USD	9	na
Hikma Pharmaceuticals	HIK	£5,462m	2,367p	17	1.5%	6.9%	16.0%	0.3%	425m	USD	9	na
Spirent Communications	SPT	£1,502m	246p	21	1.8%	10.4%	5.3%	-3.1%	-156m	USD	9	na
IMI	IMI	£4,477m	1,653p	19	1.4%	7.5%	10.8%	27.6%	313m	GBP	8	/RoE grth/
Britvic	BVIC	£2,460m	921p	17	2.3%	9.8%	21.5%	14.2%	635m	GBP	8	/RoE grth/
Games Workshop	GAW	£3,605m	11,000p	29	1.7%	61.4%	9.6%	5.7%	-51m	GBP	8	/RoE grth/
Diploma	DPLM	£3,425m	2,750p	33	1.1%	36.9%	11.2%	8.5%	-173m	GBP	8	/RoE grth/
Dunelm	DNLM	£2,934m	1,448p	24	0.8%	18.9%	22.6%	7.5%	182m	GBP	8	/RoE grth/
Spirax-Sarco Engineering	SPX	£8,985m	12,180p	39	1.0%	20.5%	6.4%	3.5%	263m	GBP	8	/RoE grth/
Ferrexpo	FXPO	£2,790m	474p	4	13.3%	68.0%	-22.3%	48.0%	-3m	USD	7	/Fwd EPS grth/PE/
Anglo American	AAL	£44,526m	3,267p	8	2.2%	155.2%	-20.7%	22.7%	4,382m	USD	7	/RoE grth/Fwd EPS grth/
Persimmon	PSN	£10,042m	3,147p	13	7.5%	11.1%	6.1%	15.6%	-872m	GBP	7	/RoE grth/Marg grth/
Bellway	BWY	£4,333m	3,512p	10	2.4%	62.7%	9.6%	19.6%	-346m	GBP	7	/RoE grth/Marg grth/
Redrow	RDW	£2,402m	682p	9	0.9%	99.3%	13.3%	20.9%	101m	GBP	7	/RoE grth/Marg grth/
Diageo	DGE	£78,463m	3,354p	27	2.1%	5.2%	11.3%	11.4%	12,430m	GBP	7	/PEG/RoE grth/
Barratt Developments	BDEV	£7,829m	769p	10	1.0%	74.3%	10.3%	13.1%	-1,058m	GBP	7	/RoE grth/Marg grth/
Berkeley Group	BKG	£5,742m	4,721p	14	2.5%	3.8%	3.2%	9.7%	-951m	GBP	7	/RoE grth/Marg grth/
Howden Joinery	HWDN	£4,746m	795p	22	1.1%	37.0%	14.7%	10.5%	150m	GBP	7	/RoE grth/Marg grth/
Imperial Brands	IMB	£15,048m	1,590p	6	8.7%	-2.8%	1.3%	6.5%	10,325m	GBP	7	/PEG/Fwd EPS grth/
QinetiQ	QQ	£1,913m	333p	15	2.0%	8.3%	3.0%	9.3%	-143m	GBP	7	/RoE grth/Marg grth/
Rio Tinto	RIO	£76,550m	6,135p	8	5.6%	61.1%	-27.3%	3.4%	565m	USD	7	/RoE grth/Fwd EPS grth/
Airtel Africa	AAF	£3,022m	80p	11	3.6%	19.3%	21.1%	3.1%	2,233m	USD	7	/RoE grth/Int Cov/
Mondi	MNDI	£9,410m	1,938p	15	4.2%	5.3%	17.7%	5.3%	1,598m	EUR	7	/RoE grth/Marg grth/
Experian	EXPN	£24,392m	2,659p	32	1.4%	18.8%	13.7%	0.8%	3,222m	USD	7	/RoE grth/Marg grth/
Rotork	ROR	£2,993m	342p	26	3.0%	0.9%	8.3%	-0.5%	-178m	GBP	7	/PEG/RoE grth/
Croda International	CRDA	£9,116m	6,534p	31	1.4%	15.7%	8.8%	-1.0%	801m	GBP	7	/RoE grth/Marg grth/
Intertek	ITRK	£9,493m	5,882p	29	1.8%	13.3%	10.9%	0.8%	644m	GBP	7	/RoE grth/Marg grth/
Rightmove	RMV	£4,991m	578p	28	0.8%	59.8%	10.6%	-7.1%	-84m	GBP	7	/RoE grth/Marg grth/
FDM Group	FDM	£1,069m	979p	30	4.7%	7.4%	13.2%	-4.0%	-45m	GBP	7	/RoE grth/Marg grth/
Avast	AVST	£4,588m	446p	17	2.6%	3.2%	7.3%	-11.4%	529m	USD	7	/PEG/RoE grth/
Smith & Nephew	SN	£13,414m	1,526p	23	1.8%	32.6%	20.1%	-3.0%	1,410m	USD	7	/RoE grth/Marg grth/
Coats Group	COA	£840m	58p	14	1.6%	124.1%	24.8%	-9.5%	180m	USD	7	/RoE grth/Marg grth/

Source: FactSet, 17 May 2021

## Small-cap quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt 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
Trealtt plc	TET	£707m	1,185p	44	0.5%	43.6%	7.9%	19.2%	5m	GBP	7	/RoE grth/FCF/

Source: FactSet, 17 May 2021

Continued on next page

## Aim quality selection (passing at least 7 of 9 tests)

Name	TIDM	Mkt 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
Gamma Communications	GAMAE	£1,731m	1,810p	29	0.6%	14.4%	14.0%	10.4%	-35m	GBP	9	na
EMIS	EMIS	£762m	1,204p	22	2.7%	6.6%	6.5%	8.1%	-46m	GBP	9	na
Renew	RNWH	£488m	620p	13	1.3%	7.6%	12.3%	18.3%	15m	GBP	9	na
RWS	RWS	£2,485m	639p	25	1.4%	14.7%	20.2%	0.1%	38m	GBP	9	na
Keystone Law	KEYS	£203m	650p	36	2.6%	13.6%	11.8%	4.0%	-6m	GBP	9	na
Pan African Resources	PAF	£373m	19p	5	3.6%	85.4%	21.8%	-12.9%	62m	USD	9	na
boohoo	BOO	£4,026m	319p	28	0.0%	24.8%	26.3%	-12.9%	-258m	GBP	9	na
Jubilee Metals	JLP	£449m	20p	6	0.0%	111.4%	78.9%	55.0%	1m	GBP	8	/Marg grth/
Steppe Cement	STCM	£116m	53p	12	4.7%	2.5%	26.9%	45.2%	-1m	USD	8	/Marg grth/
Kape Technologies	KAPE	£677m	303p	17	0.0%	58.1%	22.8%	49.8%	-6m	USD	8	/Marg grth/
Cerillion	CER	£180m	610p	40	0.9%	21.5%	3.7%	38.6%	-2m	GBP	8	/PEG/
Sylvania Platinum	SLP	£373m	137p	4	1.2%	155.9%	25.0%	19.1%	-49m	USD	8	/PE/
K3 Capital	K3C	£232m	337p	21	2.0%	23.8%	6.6%	20.2%	-8m	GBP	8	/RoE grth/
M.P.Evans	MPE	£408m	748p	20	2.9%	35.0%	13.6%	20.2%	57m	USD	8	/Marg grth/
Franchise Brands	FRAN	£126m	132p	24	0.8%	20.1%	23.4%	29.6%	-5m	GBP	8	/RoE grth/
Watkin Jones	WJG	£606m	237p	14	3.1%	6.2%	11.3%	20.9%	40m	GBP	8	/RoE grth/
Intel	FNTL	£212m	219p	17	1.3%	10.6%	8.2%	17.2%	25m	GBP	8	/RoE grth/
Atalaya Mining	ATYM	£495m	358p	8	0.0%	126.3%	18.8%	13.3%	-5m	EUR	8	/RoE grth/
Trans-Siberian Gold	TSG	£100m	115p	7	6.9%	122.1%	15.0%	13.3%	7m	USD	8	/Marg grth/
Alliance Pharma	APH	£499m	93p	16	1.7%	9.2%	13.5%	7.1%	113m	GBP	8	/RoE grth/
Solid State	SOLI	£75m	880p	16	1.4%	10.7%	6.8%	18.1%	-2m	GBP	8	/Marg grth/
SDI	SDI	£168m	171p	24	0.0%	114.8%	28.2%	7.5%	3m	GBP	8	/Marg grth/
Springfield Properties	SPR	£153m	150p	10	2.2%	50.4%	28.5%	10.3%	37m	GBP	8	/RoE grth/
Science Group	SAG	£142m	345p	17	1.7%	3.6%	3.1%	7.8%	-10m	GBP	8	/PEG/
CareTech	CTH	£620m	547p	11	2.3%	12.6%	9.2%	5.2%	352m	GBP	8	/Int Cov/
Sureserve	SUR	£120m	75p	12	1.3%	52.4%	11.1%	9.6%	-3m	GBP	8	/Marg grth/
Anglo Asian Mining	AAZ	£162m	142p	8	5.0%	2.9%	21.0%	-5.7%	-21m	USD	8	/Marg grth/
Caledonia Mining Corp	CMCL	£124m	1,065p	5	2.8%	28.6%	36.1%	-7.4%	-9m	USD	8	/FCF/
Learning Technologies	LTG	£1,245m	168p	32	0.4%	15.7%	16.4%	-2.7%	-61m	GBP	8	/PEG/
Frontier Developments	FDEV	£1,080m	2,745p	37	0.0%	14.2%	69.4%	-8.7%	-12m	GBP	8	/PEG/
Michelmersh Brick P	MBH	£128m	136p	17	1.8%	59.6%	10.1%	-7.2%	0m	GBP	8	/RoE grth/
Team17	TM17	£907m	690p	35	-	5.8%	10.4%	-17.1%	-60m	GBP	8	/PEG/
ASOS	ASC	£4,952m	4,960p	31	0.0%	20.1%	8.4%	-6.4%	238m	GBP	8	/RoE grth/
Enwell Energy	ENW	£61m	19p	10	0.0%	86.1%	131.6%	-19.4%	-44m	USD	8	/RoE grth/
Water Intelligence	WATR	£132m	855p	43	0.0%	95.7%	13.9%	67.0%	-1m	USD	7	/RoE grth/Marg grth/
Focusrite	TUNE	£763m	1,300p	34	0.3%	35.2%	-18.0%	29.2%	-19m	GBP	7	/RoE grth/Fwd EPS grth/
Tracsis	TRCS	£246m	840p	26	0.2%	9.0%	34.5%	28.0%	-19m	GBP	7	/PEG/RoE grth/
Somero Enterprises.	SOM	£258m	460p	16	5.6%	19.3%	7.5%	24.3%	-25m	USD	7	/RoE grth/Marg grth/
Instem	INS	£148m	680p	28	0.0%	9.3%	34.8%	34.7%	-25m	GBP	7	/PEG/RoE grth/
Alumasc	ALU	£79m	219p	9	2.4%	167.3%	7.9%	37.4%	6m	GBP	7	/RoE grth/Marg grth/
Character Group	CCT	£131m	615p	14	1.5%	143.9%	4.2%	40.6%	-33m	GBP	7	/RoE grth/Marg grth/
Alpha Financial Markets	AFM	£346m	325p	21	0.6%	2.8%	9.1%	25.0%	-30m	GBP	7	/PEG/Marg grth/
Eleco	ELCO	£104m	125p	26	0.3%	-3.1%	8.5%	23.2%	-4m	GBP	7	/PEG/Fwd EPS grth/
Central Asia Metals	CAML	£482m	274p	9	5.1%	79.7%	-6.0%	14.9%	24m	USD	7	/RoE grth/Fwd EPS grth/
Amiad Water Systems	AFS	£99m	325p	38	0.0%	16.8%	19.8%	32.7%	-2m	USD	7	/Marg grth/Int Cov/
Next Fifteen Comms	NFC	£787m	850p	18	0.8%	15.0%	8.8%	25.4%	29m	GBP	7	/RoE grth/PE/
Nichols	NICL	£557m	1,510p	31	2.4%	68.8%	33.5%	23.5%	-44m	GBP	7	/RoE grth/Marg grth/
Breedon	BREE	£1,792m	106p	23	0.0%	46.2%	41.1%	25.5%	318m	GBP	7	/RoE grth/Marg grth/
Best of the Best	BOTB	£267m	2,840p	20	0.1%	234.4%	14.3%	9.2%	-11m	GBP	7	/Marg grth/Int Cov/
SigmaRoc	SRC	£234m	84p	17	0.0%	15.6%	9.3%	18.4%	44m	GBP	7	/RoE grth/Int Cov/
Xpediator	XPD	£81m	57p	13	2.6%	14.6%	6.8%	29.5%	25m	GBP	7	/RoE grth/Int Cov/
CVSG	CVSG	£1,528m	2,160p	30	0.3%	59.4%	8.4%	21.8%	143m	GBP	7	/RoE grth/Int Cov/
Advanced Medical Sols	AMS	£577m	268p	28	0.6%	67.2%	17.5%	14.1%	-43m	GBP	7	/RoE grth/Marg grth/
Dewhurst	DWHT	£105m	2,090p	-	0.6%	-	-	11.5%	-15m	GBP	7	/PEG/Fwd EPS grth/
Tandem	TND	£31m	585p	-	1.5%	-	-	12.5%	-4m	GBP	7	/PEG/Fwd EPS grth/
Netcall	NET	£100m	68p	45	0.4%	29.9%	22.2%	13.4%	-5m	GBP	7	/Marg grth/Int Cov/
Titon	TON	£14m	130p	15	2.7%	1323.1%	31.1%	19.8%	-4m	GBP	7	/RoE grth/Marg grth/
Amino Technologies	AMO	£108m	142p	15	1.3%	25.8%	10.3%	10.5%	-5m	USD	7	/RoE grth/Marg grth/
Mattioli Woods	MTW	£212m	750p	15	2.7%	-12.4%	24.1%	0.0%	-15m	GBP	7	/PEG/Fwd EPS grth/
Anpario	ANP	£129m	555p	25	1.6%	3.7%	2.9%	1.8%	-16m	GBP	7	/PEG/RoE grth/
Anexo	ANX	£151m	130p	8	1.2%	28.3%	17.9%	-4.8%	40m	GBP	7	/RoE grth/FCF/
Venture Life	VLG	£105m	84p	24	0.0%	-18.3%	5.5%	-1.8%	-31m	GBP	7	/PEG/Fwd EPS grth/
Wynnstay	WYN	£95m	470p	14	3.1%	22.6%	4.7%	5.0%	-8m	GBP	7	/RoE grth/Marg grth/
Judges Scientific	JDG	£372m	5,900p	30	0.9%	9.9%	10.7%	-6.9%	11m	GBP	7	/PEG/RoE grth/
EKF Diagnostics	EKF	£296m	65p	30	1.7%	6.9%	-41.3%	-15.6%	-20m	GBP	7	/RoE grth/Fwd EPS grth/
Dewhurst plc Class A	DWHA	£105m	760p	-	1.7%	-	-	-10.6%	-15m	GBP	7	/PEG/Fwd EPS grth/
Keywords Studios	KWS	£1,867m	2,492p	37	0.0%	22.9%	13.0%	-7.9%	-66m	EUR	7	/PEG/RoE grth/
Tristel	TSTL	£264m	560p	57	1.2%	-32.8%	21.1%	-16.8%	-1m	GBP	7	/PEG/Fwd EPS grth/
Vollex	VLX	£503m	320p	18	1.0%	11.8%	14.8%	-7.8%	-16m	USD	7	/PEG/Marg grth/
MTI Wireless Edge	MWE	£61m	69p	-	2.1%	-	-	-14.4%	-7m	USD	7	/PEG/Fwd EPS grth/

Source: FactSet, 17 May 2021

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