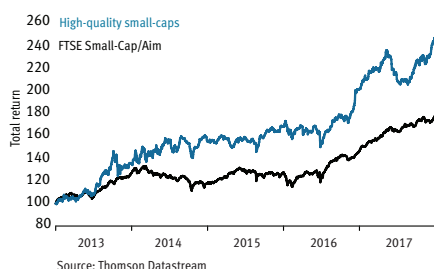




## AlphaScreens: the quest for Quality

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

### High-quality small-caps vs FTSE Small-Cap/Aim



### High-quality large-caps vs FTSE All-Share



#### Screen 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 main move on this month's FTSE All-Share quality screen, sees **Photo-Me International (PHTM)** drop out of the list of companies that pass all nine screen tests. Forecast earnings growth has been down-graded following bad news for the photo booth business in Japan, so an important test of quality is now failed.
- In the FTSE All Small, small-cap index screen (which has some over-lap with smaller companies also included in the FTSE All Share), **Air Partner (AIR)** rises and now has a 9/9 score.
- Finally, our Aim market screen sees **IG Design Group (IGR)** and **Walker Greenbank (WGB)** as new entries to the perfect score club.

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**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

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 – ie before the impact of debt.

- An operating margin higher than the median average (mid-ranking) stock in each of the past three years (ie 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 (ie again, quality that shows some signs of persistence).
- RoE higher than it was two years ago (ie 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 (ie not a suspiciously cheap or dangerously expensive valuation).
- Interest cover of less than five (ie 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	Forward NTM PE	DY	FY EPS Grth +1	FY EPS Grth +2	3-month momentum	Net cash/debt(-)	Currency	Tests passed (out of 9)	Tests failed
Victrex	LSE:VCT	£2,628m	3,060p	23	1.8%	11.7%	0.5%	22.2%	92m	GBP	9	na
Ashtead	LSE:AHT	£11,568m	2,371p	15	1.2%	26.4%	18.5%	18.2%	-2,629m	GBP	9	na
Diageo	LSE:DGE	£68,352m	2,786p	23	2.3%	6.9%	7.9%	12.5%	-9,105m	GBP	9	na
HomeServe	LSE:HSV	£2,950m	895p	25	2.1%	8.5%	9.5%	22.9%	-238m	GBP	9	na
Diploma	LSE:DPLM	£1,397m	1,235p	22	1.9%	9.8%	4.6%	15.6%	18m	GBP	9	na
RELX	LSE:REL	£32,094m	1,626p	19	2.4%	3.9%	6.6%	8.4%	-4,775m	GBP	9	na
Reckitt Benckiser	LSE:RB.	£43,495m	6,160p	19	2.7%	3.5%	7.2%	7.3%	-10,736m	GBP	9	na
Bellway	LSE:BWY	£4,030m	3,281p	8	3.7%	13.9%	5.5%	7.2%	-131m	GBP	9	na
Spirax-Sarco Engineering	LSE:SPX	£4,779m	6,495p	27	1.3%	11.3%	5.5%	7.4%	-374m	GBP	9	na
Persimmon	LSE:PSN	£8,426m	2,687p	10	8.7%	8.9%	2.6%	6.1%	1,303m	GBP	9	na
Unilever	LSE:ULVR	£109,935m	4,067p	20	3.2%	2.4%	9.3%	7.1%	-20,421m	EUR	9	na
Barratt Developments	LSE:BDEV	£5,625m	556p	8	7.7%	5.5%	5.4%	5.0%	166m	GBP	9	na
XP Power Limited	LSE:PPP	£669m	3,500p	20	2.2%	21.9%	8.2%	3.8%	-9m	GBP	9	na
Redrow plc	LSE:RDW	£2,140m	594p	7	3.7%	14.7%	8.1%	-0.1%	-35m	GBP	9	na
The Sage Group	LSE:SGE	£7,164m	661p	19	2.3%	9.7%	7.2%	-4.3%	-656m	GBP	9	na
Rightmove plc	LSE:RMV	£4,670m	5,168p	29	1.1%	10.0%	9.5%	22.3%	25m	GBP	8	/RoE grth/
Games Workshop	LSE:GAW	£951m	2,940p	18	4.4%	94.0%	-24.5%	29.3%	29m	GBP	8	/Fwd EPS grth/
Experian plc	LSE:EXPX	£16,932m	1,869p	24	1.8%	6.5%	8.9%	15.8%	-3,475m	USD	8	/Marg grth/
Halma plc	LSE:HLMA	£5,418m	1,429p	29	1.0%	8.5%	5.1%	19.6%	-220m	GBP	8	/PEG/
Moneysupermarket.com	LSE:MONY	£1,720m	321p	19	3.3%	-2.1%	8.3%	11.9%	35m	GBP	8	/Fwd EPS grth/
Safestore	LSE:SAFE	£1,169m	557p	20	2.5%	13.7%	5.5%	7.9%	-423m	GBP	8	/RoE grth/
Smiths	LSE:SMIN	£6,979m	1,764p	18	2.5%	-2.3%	11.2%	10.6%	-961m	GBP	8	/Fwd EPS grth/
Croda International	LSE:CRDA	£6,428m	4,924p	26	1.6%	6.6%	7.4%	6.7%	-382m	GBP	8	/RoE grth/
Whitbread	LSE:WTB	£7,520m	4,114p	15	2.5%	3.0%	7.4%	6.8%	-841m	GBP	8	/RoE grth/
AG BARR	LSE:BAG	£789m	694p	22	2.2%	2.0%	8.8%	7.4%	15m	GBP	8	/RoE grth/
Wizz Air	LSE:WIZZ	£2,653m	3,647p	16	-	16.6%	19.6%	7.0%	947m	EUR	8	/RoE grth/
Mondi	LSE:MNDI	£10,024m	2,072p	14	2.6%	12.9%	4.6%	4.8%	-1,326m	EUR	8	/RoE grth/
Taylor Wimpey	LSE:TW.	£6,082m	186p	9	8.1%	6.1%	4.0%	0.9%	512m	GBP	8	/RoE grth/
British American Tobacco	LSE:BATS	£84,484m	3,694p	12	5.3%	4.6%	8.2%	-12.5%	-46,094m	GBP	8	/PE/
Polymetal International	LSE:POLY	£2,995m	662p	9	5.0%	11.0%	24.3%	-12.7%	-1,420m	USD	8	/RoE grth/
Card Factory	LSE:CARD	£661m	193p	10	12.6%	-2.2%	4.0%	-9.3%	-161m	GBP	8	/Fwd EPS grth/
Photo-Me International	LSE:PHTM	£428m	113p	12	6.2%	-0.5%	-3.2%	-35.6%	45m	GBP	8	/Fwd EPS grth/
ZPG	LSE:ZPG	£2,124m	490p	27	-	16.4%	11.3%	49.5%	-317m	GBP	7	/RoE grth/PE/
NEXT	LSE:NXT	£8,319m	6,126p	14	2.6%	2.4%	4.1%	27.3%	-1,047m	GBP	7	/RoE grth/Marg grth/
The Berkeley Group	LSE:BGK	£5,586m	4,177p	9	2.6%	16.0%	-32.1%	12.6%	633m	GBP	7	/PEG/Fwd EPS grth/
ITV	LSE:ITV	£6,789m	170p	11	4.6%	-5.4%	1.2%	14.0%	-932m	GBP	7	/PEG/Fwd EPS grth/
Kainos Group	LSE:KNOS	£491m	415p	33	1.6%	30.7%	10.2%	21.3%	29m	GBP	7	/RoE grth/PE/
FDM Group (Holdings)	LSE:FDM	£1,220m	1,128p	33	2.5%	6.4%	8.1%	12.9%	37m	GBP	7	/Int Cov/PE/
Howden Joinery	LSE:HWDN	£3,197m	529p	16	2.1%	7.6%	7.8%	10.0%	241m	GBP	7	/RoE grth/Int Cov/
Imperial Brands	LSE:IMB	£24,938m	2,626p	10	6.5%	-1.1%	2.6%	6.1%	-12,448m	GBP	7	/Fwd EPS grth/Int Cov/
IMI	LSE:IMI	£3,213m	1,193p	17	3.3%	7.1%	9.0%	4.5%	-251m	GBP	7	/RoE grth/Marg grth/
NMC Health	LSE:NMC	£7,429m	3,568p	33	0.4%	59.8%	12.1%	3.0%	-1,011m	USD	7	/Int Cov/PE/
Dairy Crest Group	LSE:DCG	£774m	502p	14	4.5%	-0.1%	4.0%	-3.1%	-271m	GBP	7	/Fwd EPS grth/FCF/
BT Group	LSE:BT.A	£20,720m	210p	8	7.3%	-5.7%	0.5%	-7.8%	-10,725m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 18 June 2018

## Alpha Quality screen: small-cap results

Name	TIDM	Market cap	Price	Forward NTM PE	DY	FY EPS Grth +1	FY EPS Grth +2	3-month momentum	Net cash/debt(-)	Currency	Tests passed (out of 9)	Tests failed
XP Power	LSE:PPP	£669m	3,500p	20	2.2%	21.9%	8.2%	3.8%	-9m	GBP	9	na
Air Partner	LSE:AIR	£56m	109p	12	5.0%	13.3%	8.1%	-29.3%	15m	GBP	9	na
MJ Gleeson	LSE:GLE	£414m	762p	14	3.1%	10.9%	9.1%	2.8%	27m	GBP	8	/Int Cov/
Porvair	LSE:PRV	£235m	516p	26	0.8%	3.1%	4.8%	2.0%	10m	GBP	8	/RoE grth/
Ricardo	LSE:RCDO	£542m	1,015p	17	1.9%	7.6%	5.9%	1.0%	-32m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£428m	113p	12	6.2%	-0.5%	-3.2%	-35.6%	45m	GBP	8	/Fwd EPS grth/
Kainos Group	LSE:KNOS	£491m	415p	33	1.6%	30.7%	10.2%	21.3%	29m	GBP	7	/RoE grth/PE/
Vp	LSE:VP.	£410m	1,040p	11	2.5%	18.4%	5.4%	23.4%	-179m	GBP	7	/RoE grth/FCF/
Trealt	LSE:TET	£264m	455p	24	1.1%	5.0%	4.6%	4.7%	6m	GBP	7	/RoE grth/FCF/

Source: S&P CapitalIQ, 18 June 2018

## Alpha Quality screen: Aim results

Name	TIDM	Market cap	Price	Forward NTM PE	DY	FY EPS Grth +1	FY EPS Grth +2	3-month momentum	Net cash/debt(-)	Currency	Tests passed (out of 9)	Tests failed
Caledonia Mining Corp	AIM:CMCL	£121m	678p	-	-	26.6%	10.6%	35.3%	12m	USD	9	na
Elecosoft	AIM:ELCO	£66m	86p	24	0.7%	40.0%	7.8%	63.1%	1m	GBP	9	na
Focusrite	AIM:TUNE	£269m	472p	29	0.6%	10.1%	5.0%	13.4%	20m	GBP	9	na
Quixant	AIM:QXT	£279m	420p	22	0.6%	8.9%	13.6%	12.7%	4m	USD	9	na
Victoria	AIM:VCP	£1,001m	848p	28	-	21.8%	44.1%	15.4%	-97m	GBP	9	na
Somero Enterprises	AIM:SOM	£222m	394p	14	3.0%	21.6%	4.6%	4.9%	19m	USD	9	na
Belvoir Lettings	AIM:BLV	£38m	108p	9	6.5%	2.7%	5.0%	4.2%	-5m	GBP	9	na
IG Design	AIM:IGR	£313m	490p	20	1.2%	14.4%	7.9%	16.0%	4m	GBP	9	na
Redde	AIM:REDD	£550m	181p	15	5.9%	10.5%	3.0%	7.8%	-23m	GBP	9	na
AdEPT Telecom	AIM:ADT	£76m	322p	13	2.6%	3.9%	9.6%	-3.5%	-27m	GBP	9	na
Scapa Group	AIM:SCPA	£675m	439p	23	0.5%	5.3%	7.9%	-11.8%	-4m	GBP	9	na
James Cropper	AIM:CRPR	£132m	1,395p	28	0.8%	53.6%	11.1%	-12.8%	-5m	GBP	9	na
Walker Greenbank	AIM:WGB	£84m	118p	8	3.7%	0.1%	6.4%	-18.0%	-5m	GBP	9	na
Patisserie Holdings	AIM:CAKE	£495m	486p	25	0.7%	13.9%	8.7%	32.9%	29m	GBP	8	/RoE grth/
SafeCharge International	AIM:SCH	£514m	347p	23	3.7%	13.1%	12.1%	17.0%	109m	USD	8	/Int Cov/
Fulcrum Utility Services	AIM:FCRM	£156m	74p	16	2.8%	15.4%	0.9%	23.0%	9m	GBP	8	/RoE grth/
Tristel	AIM:TSTL	£141m	328p	40	1.2%	5.1%	13.7%	16.1%	5m	GBP	8	/Int Cov/
Portmeirion	AIM:PMP	£136m	1,280p	18	2.7%	11.1%	6.5%	24.9%	2m	GBP	8	/RoE grth/
Craneware	AIM:CRW	£581m	2,180p	50	0.9%	6.4%	17.3%	11.3%	52m	USD	8	/Int Cov/
Tracsis	AIM:TRCS	£156m	550p	23	0.3%	1.8%	4.9%	12.8%	18m	GBP	8	/PEG/
The Property Franchise	AIM:TPFG	£38m	148p	11	5.1%	9.4%	2.7%	6.5%	0m	GBP	8	/RoE grth/
Secure Income REIT	AIM:SIR	£1,257m	391p	25	3.2%	13.6%	3.7%	4.9%	-878m	GBP	8	/Int Cov/
Telford Homes	AIM:TEF	£331m	439p	8	3.9%	11.9%	3.3%	6.6%	-100m	GBP	8	/FCF/
Andrews Sykes	AIM:ASY	£221m	525p	-	4.5%	-	-	1.9%	20m	GBP	8	/Fwd EPS grth/
iomart Group	AIM:IOM	£400m	370p	19	2.7%	10.7%	10.9%	1.6%	-27m	GBP	8	/RoE grth/
Advanced Medical Solutions	AIM:AMS	£686m	322p	32	0.3%	8.0%	7.9%	-2.4%	62m	GBP	8	/Int Cov/
Billington	AIM:BILN	£33m	275p	9	4.2%	3.4%	-	3.3%	6m	GBP	8	/Fwd EPS grth/
Breedon	AIM:BREE	£1,365m	81p	17	-	14.8%	11.7%	-0.7%	-110m	GBP	8	/RoE grth/
Churchill China	AIM:CHH	£106m	964p	16	2.6%	8.0%	7.5%	-2.8%	16m	GBP	8	/Int Cov/
ULS Technology	AIM:ULS	£89m	137p	21	1.6%	22.4%	3.7%	-8.0%	-2m	GBP	8	/RoE grth/
Inspired Energy	AIM:INSE	£110m	18p	11	3.0%	7.2%	9.7%	-12.7%	-15m	GBP	8	/RoE grth/
LPA	AIM:LPA	£20m	163p	11	1.7%	10.8%	3.0%	-4.1%	-3m	GBP	8	/FCF/
RWS	AIM:RWS	£1,074m	393p	23	1.7%	22.2%	11.7%	-13.5%	-83m	GBP	8	/RoE grth/
Central Asia Metals	AIM:CAML	£458m	268p	7	6.2%	74.4%	-9.1%	-20.7%	-139m	USD	8	/Fwd EPS grth/
XLMedia	AIM:XLM	£263m	120p	12	4.9%	-11.3%	10.9%	-35.6%	38m	USD	8	/Fwd EPS grth/
Alliance Pharma	AIM:APH	£482m	101p	22	1.3%	-14.8%	12.3%	47.8%	-72m	GBP	7	/PEG/Fwd EPS grth/
Bioventix	AIM:BVXP	£149m	2,895p	29	3.3%	5.2%	0.8%	29.5%	6m	GBP	7	/PEG/Int Cov/
Water Intelligence	AIM:WATR	£44m	320p	39	-	4.5%	17.5%	55.7%	-1m	USD	7	/PEG/RoE grth/
Fevertree Drinks	AIM:FEVR	£3,783m	3,275p	75	0.3%	12.1%	14.7%	11.6%	51m	GBP	7	/PEG/PE/
Zytronic	AIM:ZYT	£77m	480p	17	4.0%	-4.5%	15.4%	10.2%	14m	GBP	7	/RoE grth/Fwd EPS grth/
boohoo.com	AIM:BOO	£2,391m	208p	56	-	15.3%	22.6%	21.8%	133m	GBP	7	/FCF/PE/
Arcontech	AIM:ARC	£10m	79p	17	1.3%	11.4%	15.2%	9.7%	3m	GBP	7	/RoE grth/Int Cov/
Shoe Zone	AIM:SHOE	£94m	188p	12	5.4%	2.7%	1.2%	20.2%	6m	GBP	7	/Marg grth/Int Cov/
James Halstead	AIM:JHD	£942m	453p	25	2.9%	3.5%	3.9%	6.3%	47m	GBP	7	/RoE grth/Int Cov/
Abcam	AIM:ABC	£2,654m	1,299p	39	0.8%	26.7%	4.6%	2.4%	93m	GBP	7	/Int Cov/PE/
Gateley (Holdings)	AIM:GTLY	£188m	174p	15	3.8%	15.2%	9.0%	3.5%	-7m	GBP	7	/RoE grth/Marg grth/
Nichols	AIM:NICL	£570m	1,545p	22	2.2%	2.1%	4.7%	-0.5%	36m	GBP	7	/RoE grth/Int Cov/
Gamma Communications	AIM:GAMA	£723m	770p	28	1.1%	11.0%	8.7%	2.7%	32m	GBP	7	/RoE grth/Int Cov/
dotDigital Group	AIM:DOTD	£212m	71p	21	0.8%	24.8%	22.8%	-7.9%	10m	GBP	7	/RoE grth/Int Cov/
Trakm8 Holdings	AIM:TRAK	£35m	97p	13	-	28.8%	14.1%	-0.5%	-2m	GBP	7	/RoE grth/FCF/
United Carpets	AIM:UCG	£7m	8p	5	5.0%	-4.5%	6.7%	-2.9%	2m	GBP	7	/RoE grth/Fwd EPS grth/
Dewhurst	AIM:DWHT	£56m	875p	15	1.4%	9.8%	27.6%	-11.3%	18m	GBP	7	/RoE grth/Int Cov/
NAHL	AIM:NAH	£58m	126p	7	12.7%	-16.2%	4.6%	-24.9%	-12m	GBP	7	/RoE grth/Fwd EPS grth/
Petards	AIM:PEG	£13m	22p	11	-	43.9%	14.5%	-9.4%	1m	GBP	7	/RoE grth/FCF/
Gama Aviation	AIM:GMAA	£133m	209p	10	1.3%	-15.2%	39.7%	-19.0%	-13m	USD	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 18 June 2018

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