# How to analyse companies

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# Disclaimer

- The value of your investments can go down as well as up and you may get back less than you originally invested.
- We don't offer advice, so it's important you understand the risks, if you're unsure please consult a suitably qualified financial adviser.
- Tax treatment depends on your individual circumstances and rules may change.
- Past performance is not a guide to future performance and some investments need to be held for the long term.

# Contents

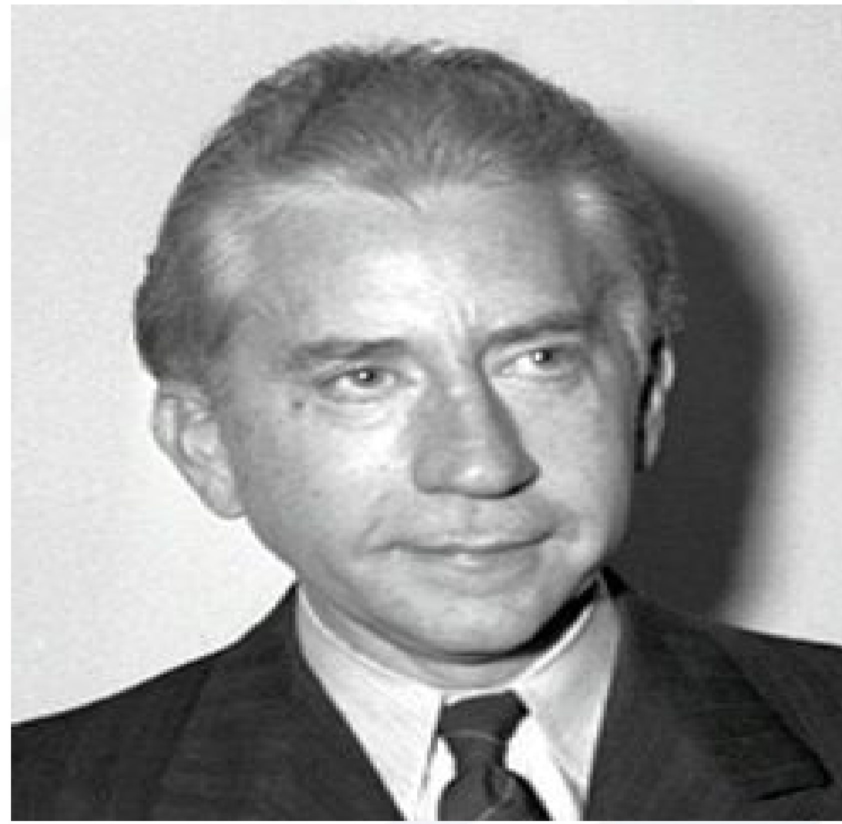
# 1. Before you start – devise a plan

- Know why you are investing and what you are trying to achieve
  - Your ultimate goal
  - Your target return
  - Your appetite for risk (best defined as capacity for permanent loss)

- The answers to these questions will help determine your
  - Style: ‘Trader’ or ‘investor’
  - Optimal asset classes
  - Most suitable instruments
  - Preferred platform provider(s)

# 2. Before you start – set your style

- Trader or investor
- “Stock certificates are deeds of ownership and not betting slips. The professional investor .... is not impatient, nor is he even in a great hurry, for he is an investor, not a gambler or speculator.” – *J. Paul Getty*
- **Growth, value, momentum, income** – all styles which may suit your personal needs (but only you know which one)



# 3. What you are looking for is an edge

- When you buy or sell an asset you are telling the market it is **<u>wrong</u>** about something
- The market is never always right but its views must be respected
- So you need a very good reason to tell the market **<u>why</u>** it is wrong: take a **<u>3D</u>** view

With thanks to Michael Cahill*: "Making the right decisions: How to Analyse Companies and Value Shares"*

- **GROWTH**
  - Better (worse) than expected
- **RISK**
  - Less (higher) than expected
  - Operational
  - Financial
  - Market
- **QUALITY**
  - Earnings and cash more (less) predictable than expected

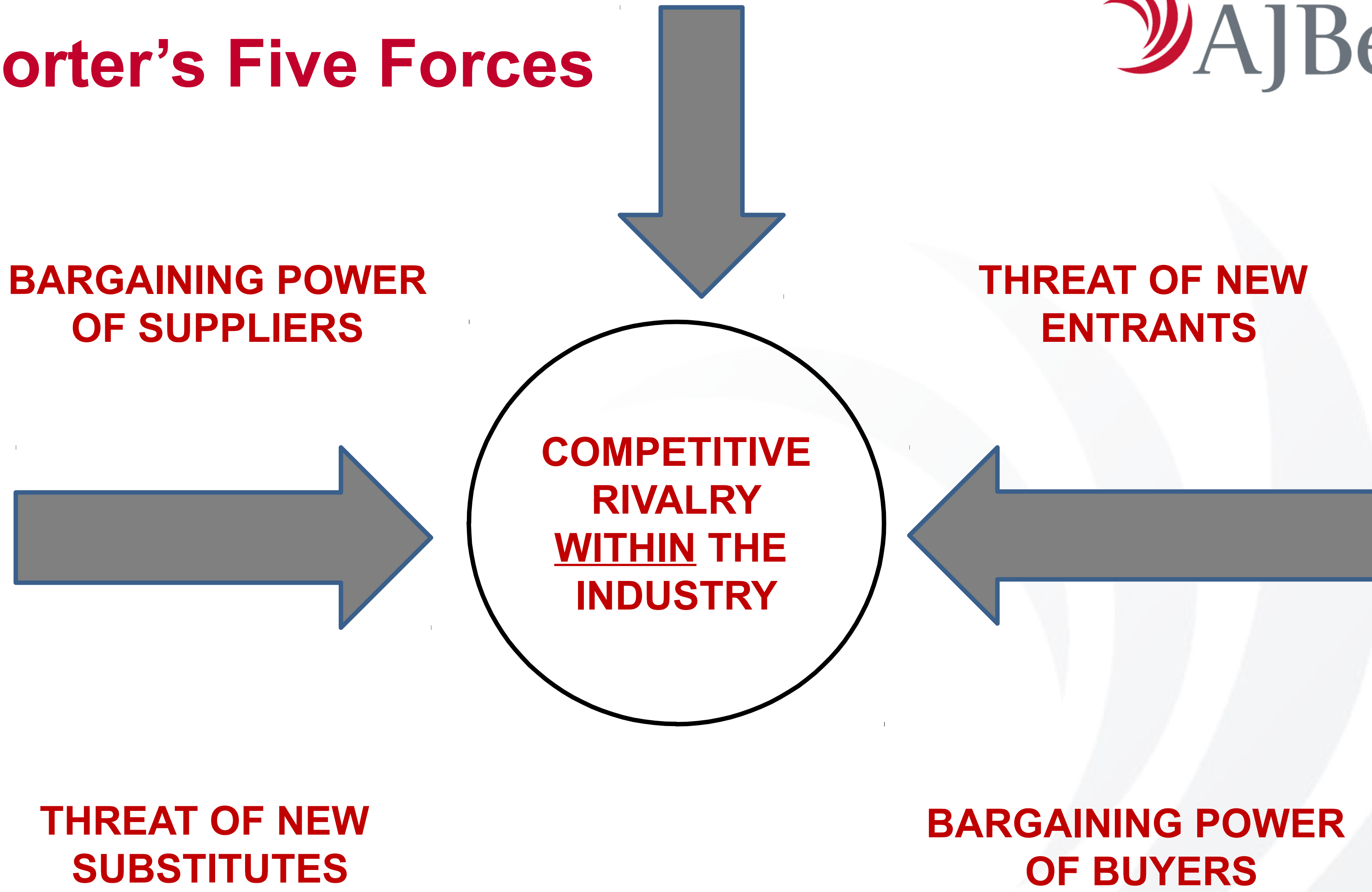
# The ultimate edge

- Remember: profits are a matter of opinion, cash is a matter of fact

- "The key to investing is not assessing how much an industry will affect society or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage" – *Warren Buffett*

- Tech, competition, regulator

# Porter's Five Forces




Source: Michael Porter: "How Competitive Forces Shape Strategy", *Harvard Business Review*, Mar-Apr 1979 edition

# Quality + an edge = cash = dividends

- Porter assesses pricing power (the true measure of competitive edge) which tends to come from brands, market share, product leadership or installed base of kit

- Pricing power means profit which means cash which means dividends

- "The type of dividend growth I want in the fund requires earnings growth – i.e., not income from debt or asset sales, which often proves <u>unsustainable</u> over the longer term."
  – *Michael Clark, portfolio manager, Fidelity MoneyBuilder Dividend fund*

# 4. Be patient: dividend growth is key

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| 2006-2015 | Divi. CAGR | Share price |
|---|---|---|
| Micro Focus | 25.1% | 1,651% |
| Pad. Power | 21.4% | 766% |
| Ashtead | 26.9% | 750% |
| Shire | 16.3% | 479% |
| Compass | 11.3% | 448% |
| DCC | 11.2% | 441% |
| Hikma | 43.1% | 399% |
| Intertek | 13.5% | 341% |
| Babcock | 16.1% | 251% |
| Bunzl | 8.4% | 242% |
| BAT | 10.7% | 239% |
| InterConti. | 12.2% | 225% |
| AB Foods | 6.9% | 213% |
| Whitbread | 11.6% | 194% |

| Sage | 13.8% | 190% |
|---|---|---|
| St. James's | 22.4% | 166% |
| Imperial B. | 10.1% | 157% |
| Next | 13.6% | 150% |
| J. Matthey | 8.0% | 135% |
| Diageo | 6.1% | 135% |
| Prudential | 8.5% | 105% |
| Vodafone | 5.4% | 77% |
| Capita | 13.4% | 74% |
| Sky | 10.4% | 55% |
| BAE | 6.3% | 32% |
| SSE | 5.0% | 17% |
| Pearson | 5.9% | -1% |
| **AVERAGE** | | **292.6%** |
| **FTSE 100** | | **14.2%** |

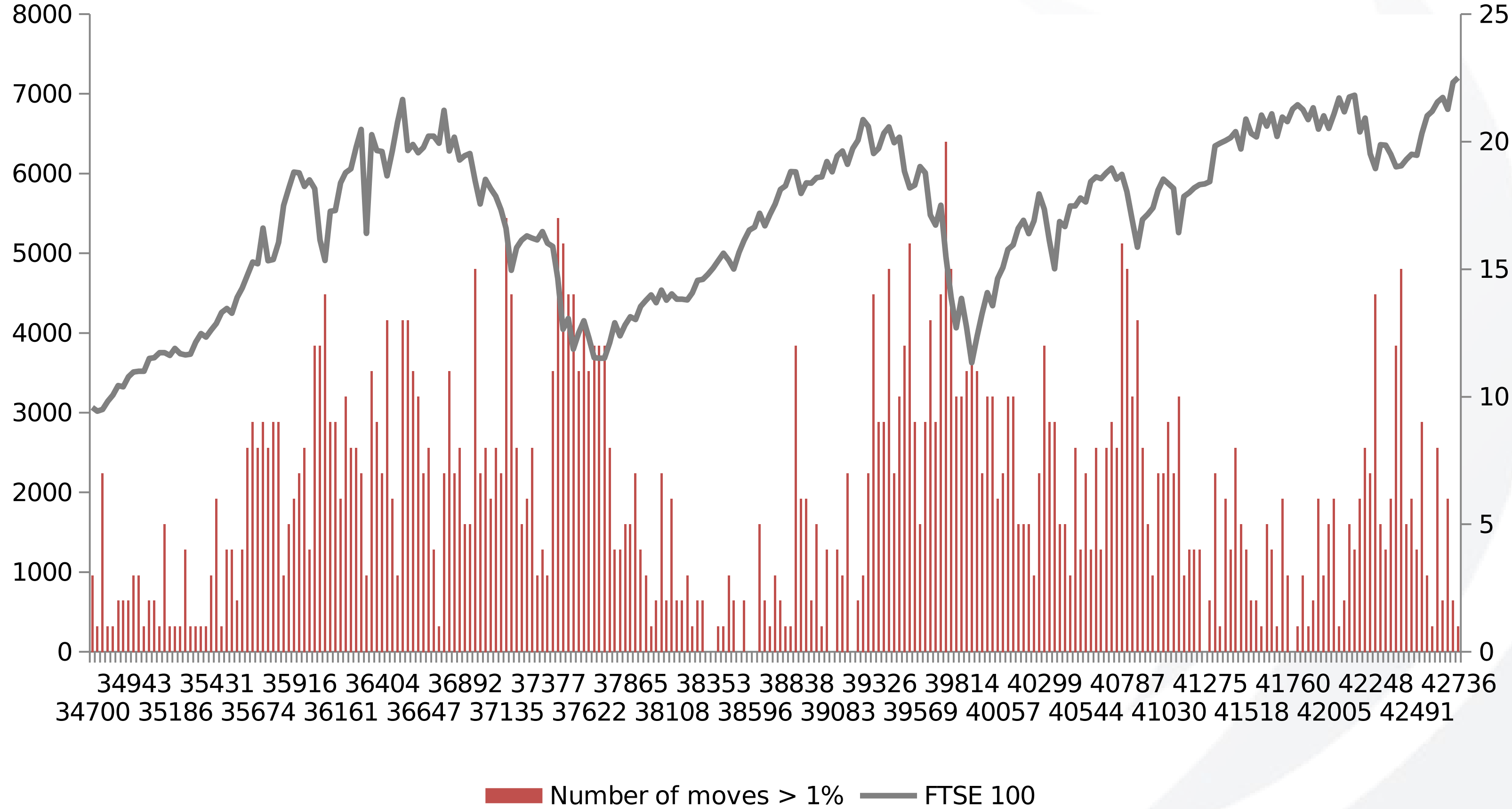
*Source: Company accounts, Digital Look, Thomson Reuters Datastream*

# Be patient

- "For investors as a whole, returns decrease as motion increases." – *Warren Buffett (on what should have been Newton's Fourth Law)*

- "Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy when others are fearful." – *Warren Buffett*

# Be patient – greed and fear




Source: Thomson Reuters Datastream

# 5. Have a checklist (or two ...)

- Do we understand the business?
- Does the business have an intrinsic value or durable competitive advantage?
- Does management have high integrity? Do we respect and admire them?
- Reasonable price?

Source: Charlie Munger: *Poor Charlie's Almanack*

# A checklist (or two ...)

**The Holy Grail**

- Scalable model
- Sustainable advantage
- Better not cheaper, revenues not costs
- Pricing power
- ROIC > WACC
- High cash conversion
- High free cashflow yield
- Low financial gearing
- Growing dividend with cover
- Strong management

- **Ten Red Flags**
- Dominant CEO (agency?)
- Frequent acquisitions
- Focus on growth (of what?)
- EPS triggers bonuses
- Frequent exceptionals
- Weak cashflow
- High operational and financial gearing
- Interest cover < 2.0
- Dividend cover < 2.0
- ROIC < WACC

# How gearing works

| WC Boggs plc (a fictional firm) | 2016 |
|---|---|
| Sales / revenue / turnover | £3,000 m |
| (Operating costs) | (£2,700 m) |
| | |
| Operating profit / EBIT / PBIT | £300 m |
| | |
| Interest on debt | (£75 m) |
| Profit before tax / EBT / PBT | £225 m |
| (Tax @ 25%) | (£56.3 m) |
| | |
| Net profit / earnings / income | £168.7 million |
| Earnings per share (EPS) | 10.0 pence |
| Dividend per share (DPS) | 4.0 pence |

With thanks to Michael Cahill: *"Making the right decisions: How to Analyse Companies and Value Shares"*

# On the upside

| WC Boggs plc rises with the tide | 2017 E – assumes 10% sales increase |
|---|---|
| Sales / revenue / turnover | £3,300 m |
| (Operating costs) | (£2,700 m) |
| | |
| Operating profit / EBIT / PBIT | £600 m |
| | |
| Interest on debt | (£75 m) |
| Profit before tax / EBT / PBT | £525 m |
| (Tax @ 25%) | (£131.3 m) |
| | |
| Net profit / earnings / income | £393.7 million |
| Earnings per share (EPS) | 23.3 pence |
| Dividend per share (DPS) | HIGHER |

With thanks to Michael Cahill: *“Making the right decisions: How to Analyse Companies and Value Shares”*

# And the downside

| WC Boggs plc gets washed away | 2017 E – assumes 5% sales decrease |
|---|---|
| Sales / revenue / turnover | £2,850 m |
| (Operating costs) | (£2,700 m) |
| | |
| Operating profit / EBIT / PBIT | £150 m |
| | |
| Interest on debt | (£75 m) |
| Profit before tax / EBT / PBT | £75 m |
| (Tax @ 25%) | (£18.8 m) |
| | |
| Net profit / earnings / income | £56.2 million |
| Earnings per share (EPS) | 3.3 pence |
| Dividend per share (DPS) | ????????? |

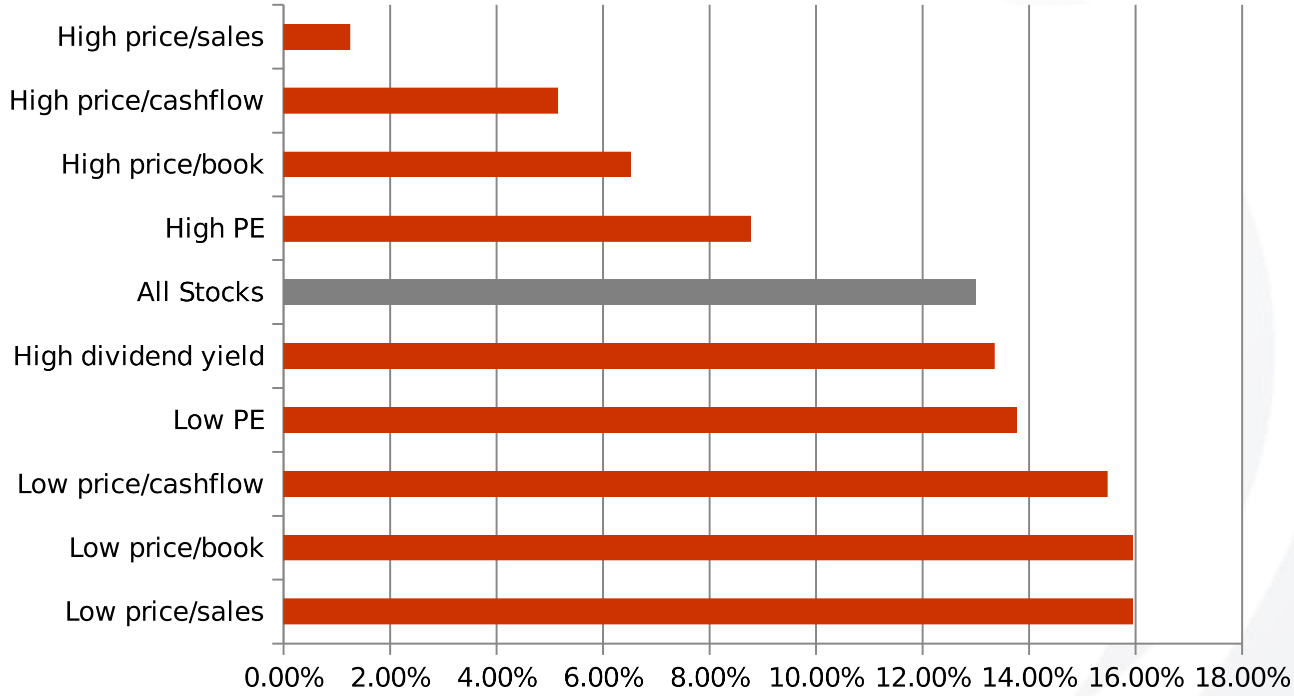
With thanks to Michael Cahill: *"Making the right decisions: How to Analyse Companies and Value Shares"*

# 6. A margin of safety

- Focus on **risk** as well as return because you could be **wrong!**
- "Operations for profit should be based not on optimism but arithmetic" – *Benjamin Graham*
- "In the short run the stock market is a voting machine but in the long run it is a weighing machine" – *Benjamin Graham*
- "Price is what you pay, value is what you get" – *Warren Buffett*

# Ignore valuation at your peril

- **Compound average annual rates of return 1951-2003: US stocks**




Source: James P. O'Shaughnessy: *What Works on Wall Street* (hat tip and thanks to Tim Price of PFP Group)

# 7. Conclusion

- **<u>It isn't easy – and it isn't supposed to be, either so h</u>ave a plan**
- Excitement and expenses are the enemy
- Focus on long-term competitive advantage
- Harvest (rising) dividends
- Manage your risk (remember AIM = 3% of UK market cap!)
- Valuation is the ultimate arbiter of your return
- No shame in using funds – just keep an eye on costs

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