

ANALYST – SUMMER 2004

By John Lander

Quality of Business

From April to August *The Analyst* put 34 companies through their Quality of Business Checklist. These were companies being screened for the first time, reviews of portfolio companies and terminal reviews. The scoring against the criteria, with the harder to satisfy criteria are in bold type, was as follows:-

Straightforward business	100%
High barriers of entry	44%
Pricing power over customers and/or suppliers	56%
Other competitive strength	85%
Stable and experienced management team	94%
Strong focus on core business	100%
Low reliance on acquisition-led growth	65%
Meaningful director holdings and no recent selling	76%
Record of returning cash to shareholders	53%
Consistent record of EPS growth	53%
Stable or expanding operating margins	47%
Superior returns on equity	79%
Low financial gearing	59%
High conversion of earnings to free cash	76%
Little political or regulatory risk	82%
Relatively stable demand for products and services	65%

Only 3 of the 34 were highlighted as 'attractive' as this required them to be 'cheap' as well as having a high score. The two highest scorers with 15 out of 16 criteria were the London Stock Exchange and Diageo. The LSE was screened for the first time and it was concluded that it should be subject to a full profile. Diageo was considered to be worthy of the portfolio but priced too highly to be purchased (May). Its price has not yet fallen low enough (to 620p) to become 'attractive'

Strategy Articles

Those published are listed below.

Corporate Warning Signs – Keith Ashworth-Lord
Summarised below

In Praise of Transparency – Keith Ashworth-Lord
The FSA consultation process calling for greater disclosure of the fees charged by investment managers.

Tales of the Unexpected – Jeremy Utton
A review of his previous Strategy pieces in 2000-2002 to see what lessons can be learnt in the passage of time.

Beyond Stocks & Shares Part 1 – Ade Roberts
Futures, options and warrants.

Beyond Stocks & Shares Part 2 – Ade Roberts
Contracts for difference spread betting and exchange traded funds.

Corporate Warning Signs

Keith Ashworth-Lord, Editor and Chief Analyst, introduced his Strategy article as "a light-hearted look at some of the warning signs that, if present to any great degree, should start the amber lights flashing". It deals with Establishment,

Personnel and Accounting. Do not be put off by “light-hearted”, the “Dozen things to look out for” under Accounting are a valuable checklist if you are not an accountant:-

1. Failure to spell out accounting policies precisely, e.g. depreciation, revenue recognition and operating of finance leasing.
2. Changes in accounting policy where seemingly plausible explanations hide an ulterior financial motive.
3. Regular reclassification of operating divisions, which is usually designed to disguise under-performance in one or more areas.
4. Rising sales accompanied by ever diminishing margins – running hard to stand still.
5. A rash of exceptional items (especially cash items) that consistently inflate the profit figure.
6. Capitalisation of expense items such as R&D, interest or precontract costs onto balance sheets as assets.
7. Lower than standard tax charges year after year, which implies that the Inland Revenue does not see the same taxable profits as do investors receiving accounts.
8. Fixed assets invariably sold at a loss implying that they have been under-depreciated to inflate profits.
9. Consistently low return on average equity or capital, especially when beneath the cost of equity or capital.
10. Two years or more declining incremental returns on equity or capital.
11. Poor conversion of accounting earnings into free cash flow year in, year out.
12. Maintaining the dividend with scant cover in order to prop up the share price.

Change of Leadership

In the June 2004 issue Jeremy Utton bowed out. At the end of his Strategy article he concluded: - “I have enjoyed writing the Strategy pieces in *Analyst* over the past fifteen years, but now it’s time for some new challenges. I wish you all the very best of good fortune in the future”. He tells us he is still a shareholder and is there in spirit!