Who can you believe?

by Malcolm Howard

If we want advice as to which shares to buy and sell, there are a number of avenues we can turn to:

- Periodicals, such as Investors Chronicle
- Various tipping sheets, of which there are many on the market
- Information supplied by the company
- Recommendations from Nominated Advisors and Brokers
- Recommendations on social media

I base my investment decisions on my own research. Primarily, I assess published accounts, but I also take into account information supplied by the company; why UKSA company visits are so valuable.

But the question is: how do you interpret the information and what can you believe?

To illustrate this, I propose to discuss one company, ***Victoria plc***.

Victoria plc is a manufacturer of carpets and operates in the UK and Australia. Several years ago, I owned shares in this company. It was a sleepy little company which made consistent profits and had little debt. The share price hardly moved from around 100p, but the dividends were reasonable. Then on 17 January 2013 the company moved from the main market to AIM and in keeping with my policy (a personal view, not a recommendation) of not owning AIM shares I sold out.

"More fool you" many would shout out as the company started an aggressive acquisition strategy and the share price soared to above 1,000p. But was this massive jump justified? The company's published EPS over four years has been volatile due to IFRS adjustments, so I use the 'Effective EPS, which is EPS based on 'cash inflow from operating activities before movement in working capital. The key measures I use are:

	Half year 15/16*	2015	2014	2013	2012
EEPS (pence)	54.5	52.9	39.2	(7.3)	45.0
Inventory (days)	142	172	153	142	167
Debtors (days)	79	88	68	57	55
Net debt per share (pence)	(536)	(249)	(21)	(107)	(112)

* Annualised as appropriate, to allow fair comparison.

Between the end of 2014 and the 2015/6 half year, revenue had increased 2.8 times, but EEPS had only increased by 40%, the reason being that while margins remained consistent, distribution and administration increased in line with sales and interest trebled as the acquisitions resulted in a significant increase in debt.

The key question here is the potential growth the company could achieve. It could be argued that growth achieved by acquisition is a 'one off'. Add in the acquisition and earnings obviously increase, but then further growth is not guaranteed. On this basis, it could be argued that EEPS would not likely increase much apart from synergy savings and accordingly I valued the share at 556p in early March 2016, when the price then was 1,505p.

On 22 March 2016 the company issued an update:

‘...group profits before tax and exceptional items will be materially ahead of current consensus market expectations for the financial year ending 2 April 2016. Recent acquisitions fully integrated and associated operational synergies have resulted in improved gross margin which we anticipate will continue into 2017. Furthermore due to continued focus on improved cash generation there will be a material reduction in group net debt and the net debt to EBITDA ration since the interim results’.

After this announcement the share price immediately increased 17% and by April 26 the share price was up to 1,468p. On that date, Cantor Fitzgerald, the company’s Nominated Advisor and Broker, issued a paper giving a target price of 1,750p, a potential upside of 19.3% on the then price.

On social media the advice was to leave the EU and buy the shares. The consensus was that as the company operated outside the EU they could not be affected by Brexit, but in my view the writers had not thought it through. Brexit impacted the property market and this might reduce the sale of carpets.

So the share price started to fall back and by 29 June it was down to 1,075p, the date cantor Fitzgerald issued a note holding its target price of 1,750p. In other words a 63% increase in price is projected.

My personal view is that some Nominated Advisors and Brokers try to talk up their client’s share price and that their recommendations are not based on either detailed research or inside information. Of course, I may be wrong. Readers can judge for themselves by comparing recommendations with forward prices.

It is a fact that AIM companies have much lighter regulation than those on the main market, which means they don’t give minimum and maximum projections; instead they can use ‘woolly’ language.

‘...group profits before tax and exceptional items will be materially ahead of current consensus market expectations.’

Well, this statement is relatively meaningless as only net profit, after all deductions, is what belongs to shareholders. Besides, how do we know what ‘consensus market expectations’ are?

‘Recent acquisitions fully integrated and associated operating synergies have resulted in improved gross margin. There will be a material reduction in Group net debt and the net debt to EBITDA ration since the interim results.’

We don’t know whether this improvement is due to increased cash generated from profits, or reduced working capital, or both. I suspected the greatest gain will come from a reduction in inventories.

Victoria plc published their accounts for the year ended 2 April 2016 at the end of July. In the event, gross margins increased only slightly from 32.6% to 33.2% and group debt only fell slightly in the last six months from £85k to £79k. The improvement was due to better working capital control (inventories down to 126 days from 147 days and debtor days down to 61 days from 79 days), something that is unlikely to be repeated. My original valuation of 556p did not take account of the synergy benefits of acquisition, but I would still argue that the price should be below 1,000p. I believe the market has not priced in Brexit and other risks, of which high debt is one. On the other hand, the NOMAD is still forecasting a price of 1,750p. Between the two forecasts there is more than 750p difference. Who do you believe?

Malcolm Howard