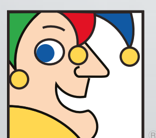
# Shares 2015

## The Investor's Guide To Outsmarting The Market



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## Mark Rogers

# INTRODUCTION

Dear Fools!

Well, 2014 turned out to be a lively year, didn't it! The underlying picture has been fraught with volatility and divergent fortunes, while the bull market has rumbled on – albeit not without casualties.

As I write this at the end of November 2014, the oil price continues to plummet. Brent Crude has crashed to levels not seen since 2009, and it's dragging oil stocks kicking and screaming down with it – from multi-billion pound global majors to the most obscure penny shares.

Oil wasn't the only sector to suffer a rout in 2014 – in early March, high-flying growth stocks were brought back down to earth with a thud, and many are yet to fully recover.

Meanwhile, the overall market has been mostly flat but there have been elusive individual winning shares across a variety of industries, from healthcare to retail. Clearly, more so than ever in this market, it pays to be selective when picking shares.

Enter *Shares 2015*, your guide to navigating the year ahead from The Motley Fool!

Inside these pages, you'll find **seven** long-term investment ideas from our top investors – shares that we believe aren't just great for 2015, but could be superb buy-and-hold investments for years to come.

You'll have to forgive me for sounding confident! But in this report, we're looking to achieve our **sixth consecutive year** of market-beating returns. That's right – *Shares 2010, Shares 2011, Shares 2012, Shares 2013 and Shares 2014* are all thrashing the FTSE, and we're back again for more!

You can check out our detailed results, which are open for the public to see, on the next page.

Now, we're not ones for blowing our own trumpet – we call ourselves Fools after all! – but with so much treacherous advice to be found on shady bulletin boards… with fund managers charging extortionate fees… and with such a challenging market to navigate… we're proud of our results.

More than that, we're proud to say that as ordinary investors, we've helped fellow Fools make money – and beat the market – with our recommendations for five years in a row with these annual reports.

Can we do it again? Will this year's picks prove as successful as the last? Sadly, it's impossible to say. But I can tell you this – we're very confident in the seven companies we're presenting to you today.

And we hope this report prepares you, no matter what 2015 brings.

Have a Foolish 2015!

M. A. Rogers

**Mark Rogers**

*Head of UK Investing*

*Motley Fool UK*

## Shares 2014 Performance

| Company | Recent Price* | Return** |
|---|---|---|
| Reckitt Benckiser (RB.) | 5,255p | 7.0% |
| TT Electronics (TTG) | 104.5p | -47.0% |
| Cohort (CHRT) | 238.5p | 9.2% |
| Greggs (GRG) | 636p | 43.9% |
| J. Smart & Co. (SMJ) | 91.5p | 0.5% |
| Rexam (REX) | 452.4p | -9.4% |
| Blackhawk Network Holdings (HAWK) | $36.32 | 59.4% |
| **Total Return** | | **9.1%** |
| **Return vs. FTSE All-Share Total Return** | | **4.4%** |

** As of: 28/11/14*
*** Cumulative: 29/11/13 to 28/11/14*
**** Last closing price as of corporate event (acquisition, delisting, spinoff, etc.).*

## Shares 2013 Performance

| Company | Recent Price* | Return** |
|---|---|---|
| Moss Bros (MOSB) | 89p | 55.4% |
| McDonald's (MCD) | $96.81 | 14.9% |
| National Grid (NG.) | 930p | 36.5% |
| Invensys (ISYS***) | 509.5p | 30.3% |
| Tasty (TAST) | 112.5p | 112.3% |
| Admiral Group (ADM) | 1240p | 19.5% |
| Daily Mail and General Trust (DMGT) | 827.8p | 60.7% |
| Premier Oil (PMO) | 187p | -43.7% |
| **Total Return** | | **35.7%** |
| **Return vs. FTSE All-Share Total Return** | | **10.3%** |

** As of: 28/11/14*
*** Cumulative: 30/11/12 to 28/11/14*
**** Last closing price as of corporate event (acquisition, delisting, spinoff, etc.).*

## Shares 2012 Performance

| Company | Recent Price* | Return** |
|---|---|---|
| Sports Direct (SPD) | 660.5p | 156.4% |
| Reckitt Benckiser (RB.) | 5,255p | 65.9% |
| Halma (HLMA) | 670p | 87.1% |
| Timeweave (TMW***) | 22p | -5.4% |
| BAE Systems (BA.) | 481.1p | 69.0% |
| Camellia (CAM) | 9,100p | -5.6% |
| CSF Group (CSFG) | 21.25p | -96.3% |
| KCOM (KCOM) | 85p | 27.5% |
| **Total Return** | | **37.3%** |
| **Return vs. FTSE All-Share Total Return** | | **6.4%** |

** As of: 28/11/14*
*** Cumulative: 07/02/12 to 28/11/14*
**** Last closing price as of corporate event (acquisition, delisting, spinoff, etc.).*

## Shares 2011 Performance

| Company | Recent Price* | Return** |
|---|---|---|
| GKN (GKN) | 345.3p | 114.0% |
| Halfords (HFD) | 478p | 42.0% |
| McKay Securities (MCKS) | 230p | 120.3% |
| Mothercare (MTC) | 183p | -63.3% |
| NCC Group (NCC) | 205.5p | 157.9% |
| Smith & Nephew (SN.) | 1,100p | 98.3% |
| Velosi (VELO***) | 165p | 61.0% |
| **Total Return** | | **75.7%** |
| **Return vs. FTSE All-Share Total Return** | | **37.4%** |

** As of: 28/11/14*
*** Cumulative: 12/11/10 to 28/11/14*
**** Last closing price as of corporate event (acquisition, delisting, spinoff, etc.)*

## Shares 2010 Performance

| Company | Recent Price* | Return** |
|---|---|---|
| PV Crystalox Solar (PVCS) | 15.3p | -50.6% |
| Nautical Petroleum (NPE***) | 450p | 643.8% |
| Goodwin (GDWN) | 3,150p | 230.9% |
| Charlemagne Capital (CCAP) | 12.4p | -7.8% |
| Tesco (TSCO) | 186.5p | -48.1% |
| GlaxoSmithKline (GSK) | 1,485p | 50.0% |
| Hansard Global (HSD) | 94.3p | -24.0% |
| Healthcare Locums (HLO***) | 0p | -100.0% |
| National Grid (NG.) | 930p | 118.4% |
| Telecom Plus (TEP) | 1,219p | 387.6% |
| **Total Return** | | **120.0%** |
| **Return vs. FTSE All-Share Total Return** | | **57.1%** |

** As of: 28/11/14*
*** Cumulative: 05/11/09 to 28/11/14*
**** Last closing price as of corporate event (acquisition, delisting, spinoff, etc.)*

**All prices are measured mid price to mid price and include reinvested dividends, but exclude any trading costs. The effects of currency movements have been ignored.**

# Rolls-Royce Holdings

"A growth story set to soar?"

By Zach Coffell

## Zach Coffell

**WHAT IT DOES:** Rolls-Royce is a power systems company. It manufactures, sells and services aircraft and ship engines.

**WHY BUY:**

Rolls-Royce is an established blue chip and its shares have fallen over 30% during 2014, creating what we think is a buying opportunity

The company operates in an industry predicted to grow for years to come

Its engineering expertise and brand power suggest it could take the lion's share of future market growth

# Rolls-Royce

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main | RR | London | www.rolls-royce.com |

| £15.9 bn | £0.5 m | 842.5 p |
|---|---|---|
| Market Cap | Net Debt (as at 31 JUL 14) | Recent Price |

Price data as at 28 Nov 14

## ▶ *Rolls-Royce*

### About the company

The name Rolls-Royce often conjures up images of the rich and famous at play. Maybe your mind jumps to David Beckham cruising in his flashy convertible, or Cristiano Ronaldo blinged up in his white Phantom.

But you may not be aware that Rolls-Royce Holdings (LSE: RR.) no longer sells or manufactures cars at all.

Now it makes its money manufacturing, selling and servicing aeroplane, ship and helicopter engines. It is the dominant manufacturer of engines for twin-aisle aircraft and large business jets, thanks to its innovative and market-leading Trent range. Indeed, we think it has a commanding market position with plenty of growth potential.

### Investment Thesis

The name Rolls-Royce is synonymous with innovation and quality, factors that have been nurtured over its 110-year history and aren't likely to disappear overnight. Its world-famous Trent engines dominate many aircraft markets, and look set to continue to do so.

Once the company has sold an engine, its profit doesn't stop there. Rolls-Royce offers life-long service contracts, and its service revenue across all segments accounted for 42% of revenues in 2013. Maintaining healthy engines is absolutely mission critical for airliners, and outsourcing engine maintenance to such a reputable brand is an attractive prospect.

Massive contracts, such as the recently won $5bn order from Delta Air Lines, play a big role in this industry. As a result, earnings can be lumpy in the short term if businesses cancel or delay projects. The continuous service revenue goes some way to placate this. Once won, larger contracts tend to increase long-term earnings visibility. With an order book of over £70bn, Rolls-Royce looks set to flourish for a good while yet.

That said, shares in Rolls-Royce have been in a nosedive this year after management announced that 2014 and 2015 revenue and profits are likely to be flat. The recent fall in the oil price has led to lower short-term demand for the Energy business, with customers delaying or cancelling orders until things brighten up.

Rolls-Royce shares now trade over 30% off their all-time high set in January 2014. Speculators and traders are running for the hills, it seems, and this could be a rare chance for us truly long-term investors to buy one of the UK's biggest success stories at what we think is a very attractive price.

Growth might not be on the immediate agenda for this engineering behemoth, but we reckon its long-term prospects still look promising.

Rolls-Royce predicts 27,000 new aircraft will be delivered worldwide before 2023, as the growing middle classes in emerging markets travel more often. This represents a 55,000-engine opportunity for the sector, and the global civil engine market as a whole could be worth $1,750bn over the period.

Over half of this predicted figure derives from twin-aisle airliners and large business jets, where Rolls-Royce has the dominant market share. If Rolls continues to lead this sector, we believe that it could experience a massive uptick in demand for its engines beyond 2015 and, consequently, a massive boost to profits.

### Financials and valuation

Trading on a P/E of 12, yielding 2.5% and with zero growth forecast in the near term, Rolls-Royce is certainly not dirt cheap.

However, truly quality companies rarely are. Warren Buffett says it best when he states that “it is far better to buy a wonderful company at a fair price, than a fair company at a wonderful price”.

In our view, the bad news is priced in right now, and I’m excited by the price offered for what I think is a wonderful company.

What’s more, management have announced a £1bn share buyback programme using proceeds from the sale of its Gas Turbines business to Siemens. Buybacks can often destroy shareholder value if instigated when the share price is too high, so it’s great to see this one implemented while we believe the valuation isn’t too demanding.

| Year ended 31 Dec | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| Sales (£m) | 11,085 | 11,124 | 12,161 | 15,513 |
| Pre-tax profits (£m) | 702 | 1,105 | 2,766 | 1,759 |
| Adjusted eps (pence) | 29 | 46 | 125 | 73 |
| Dividend per share (pence) | 16 | 20 | 18 | 22 |

## Risks

It is possible that Rolls-Royce’s markets could remain tough for longer than expected, but with an order book of £71bn, the company should be able to weather a lengthy period of subdued customer activity.

If a Rolls-Royce engine caused an accident, serious damage could be done to the brand. I’m confident that a quality track record and in-house servicing reduces this risk, but it is something to be aware of. A Trent 900 engine exploded on a flight in June 2013. Thankfully no one was hurt, and the company ended up paying a relatively small $95m compensation charge, but it goes to show that the company isn’t immune to this industry-wide risk.

## When I’d sell

The investment thesis for Rolls-Royce rests firmly on the company’s ability to out-innovate competitors, and to seize the dominant share of growth in its major markets. If new generations of Trent engines proved unpopular, I would certainly take a close look at the company.

Long-term predictions have often been wide of the mark, and if Rolls-Royce does not benefit from the rise in air travel as I believe it should, then the thesis would be broken and that could also trigger a sell.

## *Disclosure*

*As at 28 November 2014, Zach Coffell did not own any shares in Rolls-Royce Holdings.*

# Skyepharma

"The emerging pharma play with breath-taking upside potential…"

By Mark Rogers

## Mark Rogers

**WHAT IT DOES:** Skyepharma develops niche respiratory treatments, partnered with the likes of GlaxoSmithKline and Sanofi.

**WHY BUY:**

Company seems transformed after major balance sheet restructuring

Strong potential for near-term sales growth in EU and Japan

Long-term upside from potential entry into US market

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main | SKP | London | www.skyepharma.com |

| £373 m | £2.9 m | 356 p |
|---|---|---|
| Market Cap | Net Debt (as at 30 JUN 14) | Recent Price |

Price data as at 28 Nov 2014

## ***Skyepharma***

### About the Company

There's a funny investing phenomenon we've noticed over the years here at The Motley Fool. If you find a share with an ultramodern, futuristic sounding name – something with "Technologies" or "Laboratories" in the title maybe – then rather often the stock's performance doesn't quite live up to the dazzling label!

But I'm about to tempt fate today. The share I'm recommending – Skyepharma (LSE: SKP) – falls blatantly foul of this too-cool-for-school naming rule.

This emerging growth story is engaged in the business of developing inhalers for asthma sufferers and similar remedies.

After cleaning up its balance sheet last year, the major untapped international potential of Skyepharma's key product – Flutiform – could actually make this growth stock worthy of living up to its flashy name!

### Investment thesis

Skyepharma's business model seems more palatable than your average blue-sky treatment developer.

The company uses its specialist expertise to partner up with major pharmaceutical companies in each of its major regions, who act as distributors for Skyepharma's proprietary dispensers and patented treatments. Skyepharma generates cash from royalties and sales milestones agreed with the likes of Mundipharma, Sanofi and GlaxoSmithKline.

Skyepharma has transformed itself in the last few years – and I believe there could be more improvements to come, which the market is still coming around to.

Seven products launched since 2012 have come to represent 63% of the company's revenues – treatments that are in the emerging stages of potential growth, international expansion, as well as possible new applications and variants.

Skyepharma has 16 different oral and inhalation products generating revenue, but the one I'd like to single out, Flutiform, has perhaps the most exciting potential.

Developing this treatment pushed the company to its limit, but Flutiform's recent approval in Europe and Japan transformed the company's prospects – massively enhancing its potential growth, and opening the door to a drastic clean-up of Skyepharma's balance sheet, clearing £96m of bond debt. With its finances cleaned up, Skyepharma has a clear runway to focus on Flutiform's global proliferation.

Flutiform is an inhaled combination of fluticasone and formoterol for treating asthma. The combined European and Japanese market is estimated to be worth £4bn a year, and with only an estimated £70m in early sales to pharmacies in 2014, Flutiform is only scratching the surface. The potential uptake is much greater and, in my view, sales could at least double in the next few years – perhaps even more.

Crucial to this growth will be finding new adaptations for Flutiform and leveraging Skyepharma's expertise in inhaled treatments. But one major untapped area of potential growth would be an entrance into the US market, where Flutiform isn't yet approved. Skyepharma is actively looking for partners to help enter this region, and is just another area for potential upside that is not yet priced into the shares.

### Financials and valuation

Valuing a company with so many potential variables is always difficult. In this case, we must weigh up the potential success for

Skyepharma's key treatments – which also include the injectable drug EXPAREL and licensed treatments from GSK.

Obscured by a £25m exceptional charge taken this year relating to the cancellation of long-term bonds, Skyepharma should earn around £14m this year – benefiting from reduced interest charges on that cumbersome debt, and the continued scaling of EXPAREL and Flutiform.

As those interest payments continue to decline (from £27m in 2012 to little more than £2m next year), we hope they use those savings to boost Skyepharma's R&D efforts, and help to create sustained long-term value through a larger pipeline of treatments.

With Flutiform uptake rapidly expanding (our forecasts project it to double in Japan and Europe in the next 18 months), and with much of the benefit dropping into the bottom line, Skyepharma's cash-earning power could easily reach £30m by 2015/2016. This doesn't take into account the potential of new products in the pipeline, however, or the possible expansion into the US market.

I value Skyepharma at between £420m and £460m (£4 to £4.40 per share) based on the wide range of possibilities – but I believe the upside could be materially greater if new geographies and new products can be unlocked.

| Year ended 31 Dec | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **Sales (£m)** | 58.1 | 55.2 | 49.9 | 62.6 |
| **Pre-tax profits (£m)** | 6.5 | -1.0 | -10.4 | -1.0 |
| **Adjusted eps (pence)** | 15.3 | -6.70 | -36.0 | 1.70 |
| **Dividend per share (pence)** | 0 | 0 | 0 | 0 |

## Risks

Quite clearly, investing in any pharmaceutical developer – outside of the major stalwarts of the sector – presents the possibility of a higher risk profile.

And like any such company, success for Skyepharma will rely on the continued growth and success of its leading products – both existing and future, as its pipeline expands.

The shares certainly aren't cheap, either, if the likes of Flutiform falter or are made obsolete by alternative treatments without their revenues being suitably replaced. We must rely on Skyepharma using its newfound retained earnings to keep innovating in its niche. Otherwise, earnings may wane – and the market's valuation may follow suit.

This is a higher-risk investment idea, and should be approached with caution.

## When I'd sell

This is a case where I think it would be fairly easy to judge whether our thesis is playing out or not, as new products are developed and approved, and by judging the growth rates for Flutiform and EXPAREL.

It should also be easy to track Skyepharma's progression in finding a new partner to embark on a US expansion for Flutiform, or entry into alternative new geographies. So selling may prove more straightforward if Skyepharma seems unable to deliver.

However, like all our recommendations, this is one to be bought and held. I think the company can deliver, and continue to deliver, with a suite of new treatments to propel value creation over time. There could be a long and bright future ahead for Skyepharma – extravagant name and all.

## Disclosure

*As of 28 November 2014, Mark did not own shares in any of the companies mentioned.*

# Bodycote

"Big profits in a hidden industry"

By James Early

## James Early

**WHAT IT DOES:** Bodycote is the world's No. 1 provider of thermal processing services.

**WHY BUY:**

1. Dominant position affords efficiencies and negotiating power
2. Growing dividend and special dividends
3. Opportunities in higher-margin services and emerging markets

**Bodycote**

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main | BOY | Cheshire | www.bodycote.com |

**£1.22 bn**
Market Cap

**£5.5 m**
Net Debt
(as at 30 JUN 14)

**642 p**
Recent Price

Price data as at 28 Nov 2014

## ▶ *Bodycote*

### About the Company

From the birth of fire, heat and mankind have gone together. We like to stay warm. We like warm smiles, warm people, warm embraces. A bit more warmth is good enough to feel impure. Machines and gadgets, on the other hand, have a different relationship with heat. Whether it's airplane landing gear, oil pumps or engine parts, heat means wear and tear. It can't be prevented, but it can be protected against. Thermal coating of interior machine parts is about as far from the average person's mind as can it get – at least it's far from my mind – yet it's an essential and omnipresent service in our world so well populated by machines. It's also the domain of a quietly dominant company – one whose superb performance and attractive valuation could help it reward investors in a nicely overt manner. Its name is **Bodycote** (LSE: BOY).

Bodycote, with 30 years' experience and nearly 200 locations in 26 countries, is top of the little-known thermal coating industry. It serves nearly every industrial segment imaginable, from transportation to manufacturing, agriculture to healthcare. Its turnover is spread fairly well across these industries: its top 10 customers comprise less than 13% of turnover, and geographically a full 89% of its turnover comes from North America and Northern Europe. At this point very little comes from emerging markets, but that could be a growth catalyst for the future. The benefits of Bodycote's services are very real: safety, cost savings to its industrial customers in the form of longer product life and reduced maintenance labour, as well as greater energy efficiency.

### Investment thesis

I love companies that dominate their industry in the same way that a large child might dominate smaller children on the football pitch. In investing, we want to own the bully. Bodycote plays sportingly, but it's big enough to be a bully – it's three times the size of the second-largest competitor in a fragmented industry comprised of small local and regional businesses. Bodycote is the only global-sized firm in this £20bn market.

Only 7% of Bodycote's sales are to emerging markets. This is slightly misleading in that Bodycote operates in emerging markets on behalf of developed-world customers who pay it in developed markets, but the company has significant room to grow abroad – and even in southern and Eastern Europe, which comprise low-single-digit percentage amounts of its business.

A second avenue of growth is Bodycote's shift to specialty lines of its businesses, like hot isostatic processing product fabrication; we don't have to understand these processes to know that they bring in higher margins. Bodycote's sums show this, as well as that specialty segments are faster-growing: for example, Bodycote's "classical" heat treatment has delivered 9% cumulative organic growth over the past three years, whilst its "specialist" heat treatment technologies have delivered 39% organic growth for the same time period.

### Financials and valuation

Bodycote prides itself on keeping its word: its most recent presentation pointedly goes line by line to underscore promises made three years ago relative to promises kept. Management have done an admirable job of boosting return on capital employed from 10% in 2010 to 20% in 2013, while keeping free cash flow margins north of 11%.

Dividends-per-share have increased 55% over the past three years. Bodycote also saw fit to make a £19m supplemental cash distribution to shareowners in 2014, and I would not rule out future special dividends.

Best of all is that when I model Bodycote's potential future profits – even accounting for capital expenditures – my model returns a value of £8.70 per share, which, if correct, could provide investors with 40% upside from today's prices.

| Year ended 31 Dec | 2011 | 2012 | 2013 | 2014 (LTM through 30 June) |
|---|---|---|---|---|
| **Sales (£m)** | 571 | 588 | 620 | 615 |
| **Pre-tax profits (£m)** | 84 | 96 | 109 | 113 |
| **Adjusted eps (pence)** | 30 | 36 | 39 | 41 |
| **Dividend per share (pence)** | 11 | 12 | 14 | 14 |

## Risks

Bodycote, as you may have guessed, is beholden to sales to many cyclical industries. Fortunately, the company's industry diversification automatically balances out many of the ebbs and flows, but one meaningful risk is a global economic swoon. Another is acquisitions: the company is at times acquisitive, and while I strongly prefer smallish "tuck in" acquisitions like Bodycote makes to larger deals, a failed larger deal could impair value. Finally, Bodycote is a top dog in a small industry in which many big companies and possible competitors also furnish their own heat-treating services. It's possible that a big, well-funded company could pioneer a new technology that surpasses Bodycote's. But so far, Bodycote remains No. 1 by a wide berth.

## When I'd sell

Barring some drastic scandal of the sort we hope none of our companies ever has, I'd likely only sell Bodycote were its dominance to be clearly eroded by some technological change or emergent competitor. Fortunately, I don't see either as being especially likely. I'd reckon that Bodycote should give investors a nice upside as well as growing dividends – and occasional special dividends – in the years to come.

## *Disclosure*

*As of 28 November 2014, James did not own shares in Bodycote.*

# Mincon Group

"Drilling down for potentially rock-solid returns"

By Maynard Paton

## Maynard Paton

**WHAT IT DOES:** Mincon is an Irish engineering group specialising in the design, manufacture, sale and servicing of rock-drilling tools and associated products.

**WHY BUY:**

Family-run firm with high insider ownership and established industry niche

Attractive financials include high margins and cash-rich balance sheet

Disappointing trading update leaves shares on modest rating

| Market | Ticker | HQ | Website |
|---|---|---|---|
| AIM | MCON | Shannon, County Clare, Ireland | www.mincon.com |

**£107 m**
Market Cap

**£32 m**
Net Cash
(as at 30 SEP 14)

**51.5 p**
Recent Price

Price data as at 28 Nov 2014

▶ ***Mincon***

## About the Company

**Mincon** (LSE: MCON) was established in 1977, and began life manufacturing spare parts for rock-drilling rigs used by the Irish mining industry. The group has since developed its own hammer drills, and today sells a wide range of in-house designed drilling equipment and associated parts.

## Investment thesis

Mincon offers everything I like to see in a quality small cap. Key features that should help underpin solid long-term returns include proven family management, a worthwhile competitive position, solid financials and a lowly valuation.

The presence of a stable and established management team really sets this business apart for me. In particular, I like the fact that company founder Patrick Purcell ran the business for 35 years, and still remains on the board as a non-executive.

I'm also reassured that his family's substantial 57%/£69m shareholding is actively stewarded by sons Joe and Tom, who both sit as executives and have worked at the firm for about two decades. Just for good measure, chief executive Kevin Barry took on his current role in 1991, and boasts a 14%/£17m investment.

Notably, the Purcell family and Mr Barry did not sell a single share when Mincon floated in November 2013 – an impressive commitment to the business. Another positive sign is that management distributed more than €1m to employees from their own pockets to celebrate going public. Plus, boardroom pay appears reasonable and there are no option schemes – good indications to me that this business is being run for small shareholders as well as large!

True, I know nothing about heavy-duty drills used in mines. But I get the distinct impression Mincon has established a prominent niche in the sector.

Selling to 500 customers in 60 countries, the business asserts it is "The Driller's Choice" after deciding to focus on manufacturing only top-class products. Indeed, Mincon makes just about every component itself to ensure high drill quality, and to limit supply problems.

Possibly the best evidence of a top-drawer operator comes from the remarkable rescue of 33 miners in Chile during 2010 – the drill used to create the initial lifeline hole was in fact designed by Mincon. After the rescue, Joe Purcell said one of its drills had bored a 136mm wide and 700m long hole by pounding the rock 2,000 times a minute for five days. Apparently the drill involved was then placed on display in Chile's presidential palace!

Importantly, while Mincon's products are made with reliability and long service in mind, they do have a finite life. Dependent on the rock, drills can last for less than 5,000 'drill metres' and drill bits for much less. As such, the business enjoys a fair amount of recurring 'replacement' sales.

## Financials and valuation

The company's high profit margins also support the notion of a strong competitive position. Operating margins averaged 24% between 2010 and 2013, and were a fine 22% during the first half of 2014.

The balance sheet appears 'rock solid' as well, with the flotation proceeds leaving net cash at a sizeable €41m (approx.

£32m). Future cash generation should be good, too, with low capital expenditure predicted by the firm for next few years after €13m was spent building new capacity. A lack of pension complications and currency hedging derivatives underline the simple nature of the accounts.

Reported progress for 2013 has been disappointing, however. Half-year results in August admitted "*weakness in the global exploration and mining market*" had caused sales to slide 15% to €23m, and profits to dive 37% to €5m. Further woes were then revealed in November, when a third-quarter update acknowledged that own-product sales had since dropped 9%. However, the third-quarter small print did indicate the high margins had held up well, and that cash generation had been promising.

Since flotation, the share price has slipped from 73p to 58p to give a £120m market cap. At £1:€1.27, I estimate trailing profits to be something close to £8m and, adjusted for the cash pile, I calculate Mincon is valued on a P/E multiple of 11. That multiple does not look expensive to me, given the aforementioned inherent strengths of this business.

| Year ended 31 Dec | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| **Sales (€k)** | 33,821 | 41,145 | 63,143 | 52,243 |
| **Pre-tax profits (€k)** | 6,206 | 11,266 | 13,228 | 15,012 |
| **Adjusted eps (€c)** | 2.28 | 4.31 | 4.81 | 5.26 |
| **Dividend per share (€)** | - | - | - | - |

## Risks

I see two primary risks with Mincon.

First, the mining industry – which accounts for about 50% of Mincon's sales – remains depressed and there is no certainty the cycle will turn in the near future.  No doubt profits could remain under pressure, especially when the price of Mincon's drills can surpass €30,000, and the fancier drill bits can cost more than €10,000!

Second, a dumb acquisition could derail the company – as the aforementioned cash pile has all been earmarked for acquisitions to help Mincon advance its competitive position. Since flotation, €9m has been spent on three deals, but the firm has said individual purchases could be as high as €30m. Mincon's stated plan to double its size between 2014 and 2016 may prove to be too ambitious.

## When I'd sell

I'd be looking for a hasty exit if the founding Purcell family ever left the business, or the balance sheet ever became overloaded with acquisition-related debts. But I would not sell simply because weak sales continued while the mining sector was still struggling – in fact, I might even see that as an opportunity to average down.

## Disclosure

*As of 28 November 2014, Maynard did not own shares in Mincon.*

# Melrose Industries

"A publicly traded private equity/compounding machine"

By Michael Olsen, CFA

## Michael Olsen

**WHAT IT DOES:** Melrose invests in industrial companies, with an aim to buying at good prices, improving results and selling within three-to-five years.

**WHY BUY:**

1. Management possesses an enviable long-term record of buying under-valued businesses, turning them around and selling at large gains
2. An investment in Melrose affords individual investors access to a corner of the market typically off-limits: private equity
3. Today's share price fails to fully account for Melrose's long-term wealth generating capacity, in our opinion

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main | MRO | London | www.melroseplc.net |

| £2.8 bn | £750 m | 258.7 p |
|---|---|---|
| Market Cap | Net Debt (as at 30 JUN 14) | Recent Price |

Price data as at 28 Nov 14

▶ ***Melrose***

## About the company

Of the lessons that economics students learn early on, one holds enduring resonance: "there's no such thing as a free lunch". And so, if I were to present the opportunity to invest in a company whose management has earned 27% annualised returns on its investments for eight years – at a reasonable price – the more cynical might regard my offer with scepticism.

Yet, in my recommendation, **Melrose Industries** (LSE: MRO) – an investment company focused on the industrial sector – I believe we're afforded just that. As City analysts apply what I believe to be a short-termist lens to Melrose's prospects, and misunderstand its capacity to compound value, we have the opportunity to invest alongside a group of proven capital allocators at what I regard as a very reasonable price.

Established in 2005, Melrose is a unique organisation: it is equal-parts operating company, private-equity shop and turnaround specialist. Its modus operandi is to buy good industrial companies, whose results (and cash generation) do not represent their potential at what Melrose deems attractive valuations. Thereafter, management improves cash flow and margins and, within a three- to five-year period, sells the business. Chairman Christopher Miller once described Melrose as "the sickbay for unloved manufacturers". You might say it borrows traits from its US compatriots **Berkshire Hathaway** (NYSE: BRK-B) and **Leucadia** (NYSE: LUK)

Melrose typically invests in businesses offering specialised widgets, characterised by recurring purchase features, dominant market positions and, above all, solid competitive advantages – typically reinforced by the relatively niche nature of their product offerings, deep relationships with customers, as well as scale in R&D and manufacturing operations.

Currently, Melrose is invested in two businesses – Elster and Brush Turbogenerators – both possessing such characteristics. Elster, which comprises roughly 70% of group operating profits, is one of the leading purveyors of gas, electric and water meters; the majority of its operating profits derive from gas meters. Brush Turbogenerators is a leading manufacturer of turbogenerators, specialising in gas turbines for use in electrical and industrial applications, which has also built a valuable recurring revenue stream in aftermarket parts.

## Investment thesis

Over the years, Melrose has employed its "Buy, Improve, Sell" mantra to great effect – recall that 27% annualised return figure, if you will. Results in the "Improve" category are especially impressive: operating margins at Elster have improved six percentage points since the 2012 acquisition, and seven percentage points at the FKI division.

Most typically, enterprises of Melrose's ilk occupy market darling status. Today, I believe we're experiencing a unique opportunity to acquire shares – as the market has taken a short-

sighted view of Melrose's value-creating capacity, and the value inherent in its existing assets.

At its core, I think Melrose's model – of acquiring and selling businesses – offers a uniquely counter-cyclical income stream. It harvests gains when markets are flush, and hunts during periods of distress. In that regard, Melrose's underlying value is best thought of as two disparate streams – the value of its existing assets, and returns from *future* investments – a nuance I believe the market, at various points in time, does not fully appreciate. I'd suggest that this, alongside a generally skittish market, affords our opportunity today.

A cursory review of Melrose's financials fails to fully account for its long-term wealth-accruing capacity. Melrose's current investments are recorded on its balance sheet at historical cost, and gains aren't recognised until they're sold. Traditional valuation methods, particularly multiple-based methods, can also fall short on two measures: fully capturing the effects of compounded investment, *and* reflecting the current value of the company's existing investments – both hallmarks of Melrose's model.

In the most practical sense, I'd suggest that this manifests in Melrose shares occasionally appearing pricier than they are – during the improvement phase of its investments' life-cycle, in particular, or given a one- to two-year view of the business. Melrose's prospects and value-creating capacity are best measured given a 10-year view. Where City-types are hardly renowned for their investment horizon, long-term Foolish investors can exploit these idiosyncrasies – of market behaviour and valuation – to our benefit.

## Financials and valuation

Take the current state of affairs as an example: Melrose shares change hands at 1.8 times its last reported book value and 23 times trailing earnings. On a run-of-the-mill appraisal, that doesn't look cheap. But these blunt-edged heuristics fundamentally misunderstand Melrose's modus operandi.

But if Melrose were to sell its existing investments tomorrow and retain the proceeds, I estimate it would trade at approximately 1.3 times book value. That's quite reasonable for an enterprise of Melrose's calibre, in my opinion. By my maths, today's share price presumes Melrose's operations could post comparatively pedestrian 9% annualised returns on future investments, where it has earned 27% annualised. I don't think that's likely.

In my valuation estimate, I forecast just north of inflationary growth to sales and stable margins at Elster and Brush, pegging their combined worth at 190p. I've assumed Melrose posts 15% annualised returns on its investment over the next 10 years, a notable decline from past years' lofty thresholds – to account for Melrose's growth, which make fat returns harder to come by. By these measures, I believe that Melrose shares could be worth £3.45.

| | 2011 | 2012 | 2013 | 2014 (LTM) |
|---|---|---|---|---|
| **Sales (£m)** | 1,080 | 1,051 | 1,732 | 1638 |
| **Pre-tax profits (£m)** | 131 | 86 | 162 | 166 |
| **Adjusted EPS (pence)** | 15 | (1) | 11 | 11 |
| **Dividend/share (pence)** | 9 | 9 | 9 | 8 |

## Risks

Chief among the risks to an investment in Melrose are those related to personnel. In the absence of a well-defined succession plan, I'd seriously consider selling if current management departed. Likewise, while I think my valuation of Melrose's returns on future investments are reasonable, and today's share price provides some margin for error, they're not conservative.

## When I'd sell

Should management fail to deliver returns according to my expectations, or seriously overpay for a deal, shareholders' capital is at risk – and I'd reconsider my investment. Finally, because Melrose operates as a publicly traded private equity firm, it sometimes employs a lot of debt. When things are good, that juices shareholders returns. But if management bungles a deal, or the economy turns down when debt levels are high, that could be bad.

I believe that Melrose represents a truly exceptional company, where a marriage of outstanding capital allocation, operational savvy and shareholder-friendly behaviour can contribute to exceptional returns. At today's prices, I'd wager that an investment in Melrose offers two of the things it seeks in its targets: an attractive price, and potential for upside. The harder part, by my measure, is figuring out when (or whether) to sell.

## *Disclosure*

*As of 28 November 2014, Michael owned shares of Berkshire Hathaway and Leucadia but did not own shares in Melrose.*

# Porvair

"Clean, Filtered Growth from Porvair"

By Nathan Parmelee

## Nathan Parmelee

**WHAT IT DOES:** Porvair is a specialist manufacturer of industrial filters and separation equipment.

**WHY BUY:**

1. Customer relationships with Posco, Boeing, Airbus and Reliance Industries confirm Porvair's position as a technological leader for industrial filters
2. Recurring nature of sales once Porvair's filter products are included in a design
3. Porvair is focused on developing products that are specified in product designs, and their replacement is generally mandated by regulation and maintenance cycles.

porvair

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main | PRV | King's Lynn, Norfolk | www.porvair.com |

| £113 m | £1 m | 256 p |
|---|---|---|
| Market Cap | Net Debt (as at 31 MAY 14) | Recent Price |

Price data as at 28 Nov 2014

## ▶ *Porvair*

### About the Company

Porvair is one of those companies you're unlikely to give much thought to unless you're an engineer or an investor that likes to scrounge around for companies with potential long-term competitive advantages. I'm definitely in the second group, and it's clear to me that Porvair has a strong position in a number of niche markets for filters and related separation technologies.

Perhaps the clearest example of this is Porvair's leadership position in filters for commercial aviation. The company has a dominant position in filters for fuel tank inerting, coolant systems, as well as fuel and hydraulic lines. These are largely bespoke designs specific to each aircraft, and Porvair's filters are specified for use on these planes.

Porvair is well positioned to continue growing its share to this market, because of growing demand for Boeing's Dreamliner and the Airbus' A380 creating demand for new filters, regular replacement of filters for maintenance purposes, and expected ongoing 3% to 5% annual growth in miles flown that supports continued demand.

Commercial aviation is a part of Porvair's Microfiltration unit and just one area of strength for the company. This unit also has a strong presence in filters for water laboratory analysis, biosciences, nuclear remediation and both the energy and industrial industries. Porvair's Metals Filtration unit is its other business, and it makes patent-protected filters used in aluminium casting and grey/ductile iron filtration. The Microfiltration unit is the larger and faster growing of the two businesses, but the patent-protected sales in Metals Filtration make it an attractive business.

### Investment thesis

A big part of the thesis for Porvair lies in the attractive dynamics of the business. The company's products are often disposable pieces that protect systems that are far more valuable, such as aircraft, nuclear facilities and molten metal processing. This makes their purchase routine and fairly predictable.

That's a strong position to be in, because it creates recurring sales and cash flow. Management has strengthened this position by focusing on opportunities where its products are specified in the design and then has replacement cycles regulated by authorities or specified by manufacturers. Porvair doesn't disclose how much of its sales come from products specified in designs, but does highlight that 80% of sales are repeat orders.

The design specification, regulatory requirements and engineering challenges involved help to give Porvair a strong relationship with customers and a moat that protects its sales as long as it continues to work with customers and innovate. Having 30% of its sales protected by patents further strengthens Porvair's position.

Those are the underlying qualities supporting the business, and I believe the company can continue growing at 8% to 15% per year just as it has over the past five years. The three growth opportunities I see for Porvair are the continued underlying 5% to 10% underlying growth of its existing markets, the ability to further expand within those markets through innovation, and through its healthy levels of cash flow Porvair can pursue bolt-on acquisitions that allow expansion in current markets or new ones.

### Financials and valuation

In the past five years, Porvair has grown its operating profit by more than 20% per year. That's a torrid pace that is unlikely to be

sustained. However, I believe something in the neighbourhood of 8% to 12% should be achievable. With the shares trading at 11.1 times operating cash flow and 10.5 times their enterprise value-to-EBITDA (earnings before interest, taxes, depreciation and amortisation), I believe the valuation is more than reasonable given the company's growth potential.

From the table above, you'll see that revenue growth has accelerated in the past year. This is due to three large projects Porvair is currently working on for customers. Revenue growth should return to underlying levels – around 10% – in 2015, but this lumpiness can be expected from year to year when the company wins large contracts for new plants or proof-of-concept work.

| Year ended 30 Nov | 2011 | 2012 | 2013 | Trailing 12 months |
|---|---|---|---|---|
| Sales (£m) | 68.1 | 76.5 | 84.3 | 96.7 |
| Pre-tax profits (£m) | 37.7 | 65.5 | 7.9 | 8.7 |
| Adjusted EPS (pence) | 4.5 | 6.3 | 12.5 | 13.7 |

Source: S&P Capital IQ

## Risks

The consumable nature of most of Porvair's products helps to keep demand steady. However, the company does serve the energy, industrial and aluminium industries, which tend to be cyclical and can see demand slow or contract from time to time. This makes it likely that Porvair will see its growth slow on occasion, too.

Acquisitions are a part of Porvair's growth strategy, and to do date they've been executed well. However, a poorly executed acquisition or one that is too large for Porvair could disrupt its finances and its operations.

## When I'd sell

A large acquisition is more than a risk for Porvair. I believe it could upset the focus and momentum of the business and that's a potential reason to sell. In this case I would consider 'large' as anything more than 25% of revenue. Another reason to be concerned is if the company makes an acquisition outside of its core areas of filtration and separation.

The other reason I would consider selling is a change in strategy that focuses on lower quality growth. I don't believe the present management team is likely to make a radical departure from the current strategy they've put in place. So, I would pay attention to any changes at the top and keep an eye on R&D spending as well.

## *Disclosure*

*As of 28 November 2014, Nathan did not own shares of any company mentioned.*

# Abcam

"Entering a golden age of research"

By Mark Stones

## Mark Stones

**WHAT IT DOES:** Abcam sells high-margin consumables to laboratories focused mainly on the research of cancer and neurological disorders.

**WHY BUY:**

Leadership position in fast-growing industry

Products are repeat purchases that become more valuable over time

Cash-rich balance sheet and durable competitive advantage

| Market | Ticker | HQ | Website |
|---|---|---|---|
| AIM | ABC | Cambridge | www.abcam.com |

| £894 m | £56.9 m | 444 p |
|---|---|---|
| Market Cap | Net Cash (as at 30 JUN 14) | Recent Price |

Price data as at 28 Nov 2014

▶ ***abcam***

## About the Company

Founded in 1998, **Abcam** (LSE: ABC) manufactures and supplies antibodies to research scientists working on treatments for diseases such as cancer. It has a catalogue of 133,000 products, making it one of the market leaders in the $2bn-a-year antibody market.

The firm's genesis was from academic necessity: Abcam's website not only provides scientists with the physical product they need to conduct their experiments, but the technical data too, saving researchers both time and money. Abcam is embedded at the heart of research into our unmet medical needs: work that is both important and enduring.

They say invest in what you know. I have never shopped for an antibody before. But hundreds of thousands of researchers worldwide order Abcam's antibodies the way I might order my favourite coffee.

## Investment thesis

In 2001, scientists unveiled the first draft of the human genome – the complete mapping of all our genes. Thereafter, in a transformative moment for healthcare, the goal shifted to understanding what is happening within each cell, and research spend shifted to the detection and analysis of proteins that might be modified to combat disease. The antibodies Abcam sells are a crucial tool in this process. There are tens of thousands of proteins in each cell, and scientists need different antibodies to study the protein that interests them down a microscope.

This area of research underwent a boom period. In the last decade, Abcam's sales increased from £7m to £128m at an annual compound rate of 34%. I can't help but admire what I believe are the hugely powerful economics behind Abcam's business model. It has around 250,000–300,000 customers in its database, who might buy a batch of primary antibodies (at around £200) every few months. Abcam can charge a premium because of the unique data sheets it produces, detailing how the antibody will perform. Because of this, Abcam's oldest products – with the broadest range of data – command the highest prices.

These proprietary data sheets would take years for competitors to produce, gifting Abcam with a difficult-to-replicate competitive moat. Although scientists need Abcam's products to facilitate their research, and that need should not go away, it might change with time. That's why new products are regularly added to the mix to keep up with the pace of scientific research.

Last year Abcam increased its range of products by 9%. That is below recent years, as the company increases focus on in-house development. It has ramped up R&D spending, while acquisitions – such as the £100m deal for California-based Epitomics – are another way to drive growth, giving Abcam a springboard into new markets. I believe that this should prove to be the right strategy, even though margins look slightly less healthy as a result.

## Financials and valuation

At current prices, Abcam trades at around 24 times free cash flow, a multiple that underpins the prevailing view that this is a world-class business with a remarkable track record and great growth prospects.

I believe that Abcam's £890m market cap has priced in high single-digit revenue growth, although I believe that it could grow sales in excess of that. My model returns a valuation of around £1bn. But with a market share of just 11%, Abcam's upside

potential may be even greater if demand were to accelerate and it took a bigger slice of the market.

| Year ended 31 Dec | 2011 | 2012 | 2013 | LTM |
|---|---|---|---|---|
| **Sales (£m)** | 83 | 97 | 122 | 128 |
| **Pre-tax profits (£m)** | 32 | 39 | 47 | 47 |
| **Adjusted eps (pence)** | 13 | 15.6 | 17.6 | 18 |
| **Dividend per share (pence)** | 5 | 6 | 7 | 8 |

## Risks

Somewhere in the region of 80% of Abcam's revenue is thought to come from government-funded research. Austerity measures, in the event an economy stutters in a key market, might negatively affect growth. But it says a lot about the strength of the business that in 2009, despite the financial crisis, Abcam doubled earnings and dividends.

I believe the greatest risk is that the market expects Abcam to grow considerably for the next few years. That is not a problem if earnings keep rising. If that happens, today's valuation might end up looking cheap. But if the rate of expansion slows, then I doubt the market will take long to clip the company's wings.

## When I'd sell

If I bought Abcam it would not be a share I'd be looking to sell any time soon. Man hasn't yet vanquished cancer. People are living longer. Populations are rising. I think it is inevitable that healthcare provisions will increase to enable researchers to confront these challenges, driving business Abcam's way. So long as I had a diversified portfolio to offset any company-specific risks, I'd consider including Abcam as a racier growth share to hold for several years at least.

I might consider my position in the event of a radical departure in strategy – something along the lines of excessive acquisition activity, especially if this triggered large debts.

## *Disclosure*

*As of 28 November 2014, Mark did not own shares of Abcam*

## Risk Warning

The articles in *Shares 2015* reflect the opinions of the individual writers and give general advice only.

The shares mentioned may not be suitable for any individual.

You should make your own investment decisions, or consult an authorised financial adviser.

- The prices of all shares, and the income from them, can fall as well as rise.
- You run an extra risk of losing money when you buy shares in certain smaller companies including "penny shares".
- There may be a big difference between the buying price and the selling price of these shares. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, it may go down as well as up and you may not get back the full amount invested. It may be difficult to sell or realize the investment.
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