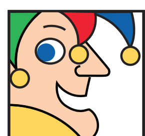
SHARES 2016

7 TOP IDEAS FOR THE YEAR AHEAD



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Mark Rogers

Introducing Shares 2016: 7 Top Ideas for the Year Ahead

Dear Fools!

What will the next 12 months look like for UK investors?

Of course, we don't claim to possess a crystal ball here at The Motley Fool…

But in one way or another, all investors — from Warren Buffett to mere mortals like ourselves — must look forward to the future when buying shares.

Future predictions can be rather tricky — especially looking forward at a single one-year period.

After all, just take a look at the *last* year!

On 24 August 2015, later referred to as **"Black Monday"**, the Chinese stock market dropped by 8.5% in a single day, sending the FTSE 100 crashing by almost 5% in a single session.

And while Foolish investors "*Kept Calm and Carried on Investing*", it's fair to say that nobody saw events like Black Monday coming at the start of 2015…

Clearly, in a market where anything can happen, it pays to be prepared.

We might not be able to guess exactly what the stock market will do over the next 12 months — in all my years of investing, I've never met anyone who can do that with any consistency.

However, we can prepare ourselves for the trials and tribulations ahead, with the benefit of research. It's with that in mind that each year, we present this annual guide for Foolish investors…

Introducing Shares 2016: 7 Top Ideas for the Year Ahead

Inside these pages, you'll find **seven** long-term investment ideas from our top investors — shares that we believe aren't just great for 2016, but could be superb buy-and-hold investments for years to come.

In this report, we're looking to achieve our **seventh consecutive edition** of market-beating returns.

You read that correctly — Shares 2010, Shares 2011, Shares 2012, Shares 2013, Shares 2014 and Shares 2015 *all beat the FTSE All-Share,* and we're back again for more this year!

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

We don't say that to boast; we're proud that as ordinary investors, we've helped fellow Fools make money with our recommendations — and beat the market! — for six years in a row, with annual reports just like this one.

Can we do it again? 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.

We hope this report prepares you well for the year ahead.

Have a Foolish 2016!

M. A. Rogers

Mark Rogers
Head of UK Investing
The Motley Fool UK

The Story So Far

SHARES 2010 THROUGH TO SHARES 2015

Shares 2010

Company	Return
PV Crystalox Solar (LSE: PVCS)	-72.4%
Nautical Petroleum (LSE: NPE)	643.8%
Goodwin (LSE: GDWN)	125.7%
Charlemagne Capital (LSE: CCAP)	-20.3%
Tesco (LSE: TSCO)	-51.5%
GlaxoSmithKline (LSE: GSK)	52.4%
Hansard Global (LSE: HSD)	15.2%
Healthcare Locums (LSE: HLO)	-100.0%
National Grid (LSE: NG)	143.6%
Telecom Plus (LSE: TEP)	375.1%
Total Return	**111.2%**
Return v FTSE All-Share TR	**47.2%**

Shares 2011

Company	Return
GKN (LSE: GKN)	95.3%
Halfords (LSE: HFD)	17.9%
McKay Securities (LSE: MCKS)	182.9%
Mothercare (LSE: MTC)	-43.1%
NCC (LSE: NCC)	274.5%
Smith & Nephew (LSE: SN)	108.4%
Velosi (LSE: VELO)	61.0%
Total Return	**99.5%**
Return v FTSE All-Share TR	**60.3%**

Shares 2012

Company	Return
Sports Direct (LSE: SPD)	183.8%
Reckitt Benckiser (LSE: RB)	111.3%
Halma (LSE: HLMA)	149.6%
Timeweave (LSE: TMW)	-5.4%
BAE Systems (LSE: BA)	98.9%
Camellia (LSE: CAM)	-2.7%
CSF (LSE: CSFG)	-96.1%
KCOM (LSE: KCOM)	64.0%
Total Return	**62.9%**
Return v FTSE All-Share TR	**31.1%**

Shares 2013

Company	Return
Moss Bros (LSE: MOSB)	94.5%
McDonald's (NYSE: MCD)	44.9%
National Grid (LSE: NG)	52.2%
Invensys (LSE: ISYS)	61.9%
Tasty (LSE: TAST)	249.1%
Admiral (LSE: ADM)	79.4%
Daily Mail (LSE: DMGT)	43.1%
Premier Oil (LSE: PMO)	-78.3%
Total Return	**68.4%**
Return v FTSE All-Share TR	**42.1%**

Shares 2014

Company	Return
Reckitt Benckiser (LSE: RB)	36.3%
TT Electronics (LSE: TTG)	-19.0%
Cohort (LSE: CHRT)	96.1%
Greggs (LSE: GRG)	203.7%
J. Smart (LSE: SMJ)	22.6%
Rexam (LSE: REX)	23.5%
Blackhawk (NASDAQ: HAWK)	107.8%
Total Return	**67.3%**
Return v FTSE All-Share TR	**61.9%**

Shares 2015

Company	Return
Rolls Royce (LSE: RR)	-26.0%
Skyepharma (LSE: SKP)	-8.8%
Bodycote (LSE: BOY)	-5.2%
Mincon (LSE: MCON)	4.1%
Melrose (LSE: MRO)	14.6%
Porvair (LSE: PRV)	17.8%
Abcam (LSE: ABC)	32.7%
Total Return	**4.2%**
Return v FTSE All-Share TR	**3.5%**

Notes on the calculation of returns

All returns are measured from mid-price to mid-price and include reinvested dividends but no trading costs. The effects of currency movements have been ignored.
Shares 2010 returns are measured from 5 November 2009 to 30 November 2015. Nautical Petroleum was taken over and delisted on 8 August 2012, and Healthcare Locums was taken over and delisted on 3 June 2013.
Shares 2011 returns are measured from 12 November 2010 to 30 November 2015. Velosi was taken over and delisted on 26 January 2011.
Shares 2012 returns are measured from 7 February 2012 to 30 November 2015. Timeweave was taken private and delisted on 13 November 2012.
Shares 2013 returns are measured from 30 November 2012 to 30 November 2015. Invensys was taken over and delisted on 16 January 2014.
Shares 2014 returns are measured from 29 November 2013 to 30 November 2015.
Shares 2015 returns are measured from 28 November 2014 to 30 November 2015.

Ted Baker

"Quality and style for the discerning investor"

By Mark Rogers

Mark Rogers

WHAT IT DOES: Ted Baker is a British luxury lifestyle brand selling high-quality suits, dresses and more.

WHY BUY:

Visionary leader with 35% stake in the business.

Unique, valuable, up-and-coming British brand.

Impressive growth opportunity overseas.

Market	Ticker	HQ	Website
Main	TED	London	www.tedbaker.com

£1.3 bn	£54 m	3,067 p
Market Cap	Net Debt (as at 15 AUG 15)	Recent Price

Price data as at 9 October 2015

▶ *Ted Baker*

About The Company

When it comes to a good suit, it rarely pays to be cheap.

"You get what you pay for" they say. And for the discerning gentleman who wishes to make an impression, it's the attention to detail that matters. The quality. It is an extension of the person, subtle, assuring, like a firm handshake.

It's about more than just the brand label or the price tag. These are lesser concerns to the gentleman. For the discerning gent, above all else, "it has to be right". Well fitting, with timeless quality and charming, irreverent style.

The same could be said for the discerning *investor*. "Price is what you pay. Value is *what* you get."

British lifestyle brand **Ted Baker** (LSE: TED) has rarely ever looked "cheap" by conventional value metrics — but the shares have delivered a four-fold gain to investors in the last four years, courtesy of the company's rapid expansion.

Those who have become wealthy investing in Ted Baker to date were not those who winced at the "expensive" label attached to the shares at various points during their meteoric rise. Could the same be true today, as Ted Baker sells more of its high-value dresses and suits to affluent consumers around the world?

Investment Thesis

Ted Baker's unwaveringly British brand is a true UK business success story, expanding from a single store in Glasgow to become a luxury lifestyle brand that has delivered more than a 30-fold total return to investors since 1997. That's no coincidence — sales have grown every single year from £14m to £388m since then and, astonishingly, Ted Baker has achieved this without ever having a formal advertising campaign.

The man behind Ted Baker's meteoric rise is fashion entrepreneur Ray Kelvin, who still runs the company today. The son of a dressmaker in North London, his personality is woven into Ted Baker's business and product lines — unlike a stereotypical flamboyant fashion boss, Kelvin is down to earth, shuns media attention and is rarely photographed in public.

Kelvin has played a critical role in the development of the brand, and Ted Baker's unique culture and personality — and he's an important part of our thesis here. At The Motley Fool, we love to see businesses that are still run by their founders, with substantial "skin in the game". Ray Kelvin owns 35% of Ted Baker, and I'm excited to see how far this visionary leader can take the company.

This great British success story is increasingly becoming a global one. From almost nothing a decade ago, Ted Baker now generates more than £90m of sales overseas. And in my opinion, Ted Baker is only just beginning to fully leverage its brand globally.

Compared to the likes of **Burberry**, Ted Baker is barely scratching the surface of its international potential. As recently as 2002, Burberry sold just £124m of its high-margin luxury wares abroad. Today, it sells more than £2 billion outside of the UK. Could Ted Baker do something similar in the next ten years?

I think Ted Baker has the brand, the culture and the management team to potentially become the next British fashion brand to be a major global success — especially as disposable incomes rise among emerging market consumers.

Financials And Valuation

Ted Baker's shares trade just over £30, roughly 28 times its expected earnings for this year. Ted Baker has confounded value investors for years by consistently exceeding the growth priced into the shares — is the same true today?

Looking at this opportunity through a "growth investor" lens, like we might in our Fire recommendations at Share Advisor, it's important to consider the market opportunity, the quality of the brand and management team, and the growth potential on offer.

Ted Baker has a tremendous track record of growth, routinely achieves double-digit operating margins and has delivered an average return-on-capital (a useful quality measure) of 19% over the past three years. It is currently a £1.3bn company with £388m of sales globally — but I think Ted Baker could achieve more than £1bn in sales in the next decade, if it continues to successfully expand, and take advantage of its market opportunity.

In this event, it's possible that Ted Baker could become a £4bn business (three times more valuable than today) between now and 2025, if the company's ambitious global plans succeed.

Year ended 31 Jan	2012	2013	2014	2015
Sales (£m)	216	254	322	388
Pre-tax profits (£m)	24	32	40	50
Adjusted eps (pence)	40	58	69	83
Dividend per share (pence)	21	24	28	35

Data from S&P CapitalIQ.

Risks & When I'd Sell

I'm a big fan of Ted Baker's charming, unmistakeably British brand — and I'm bullish on the company's long-term prospects with Ray Kelvin in charge.

There's some degree of key-man risk here, though, if the unconventional Kelvin either departed from the business, or somehow "lost his touch" in the fast-moving world of fashion. Personally, I believe Kelvin (aged 60) still has a large runway in front of him, and remains as sharp today as ever. I might begin to look toward the exit, however, if Kelvin stepped away from operations.

Lastly, Ted Baker's international growth will depend on global demand from consumers overseas — this means a greater exchange rate risk, and an expectation for consumers in emerging economies to (eventually) prosper. If we saw signs that Ted Baker was failing to gain traction in these economies, we might reconsider our position.

Disclosure: As at 9 October 2015, Mark owned shares in Burberry but no other company mentioned.

Whitbread

"A caffeine injection for your portfolio"

By Zach Coffell

Zach Coffell

WHAT IT DOES: Whitbread owns Costa Coffee and Premier Inn.

WHY BUY:

1. Whitbread's brands have dominant positions in the UK.
2. The company is looking to start another phase of expansion over the next few years.
3. Its brands are both replicable and highly profitable.

WHITBREAD PLC

Market	Ticker	HQ	Website
Main	WTB	Dunstable	www.whitbread.com

£8.4 bn	£583 m	4,620 p
Market Cap	Net Debt (as at 26 FEB 15)	Recent Price

Price data as at 9 October 2015

▶ ***Whitbread***

About The Company

If you've read any of our analysis here at The Motley Fool, you'll probably know we are very keen on businesses that possess strong brands. We also pay attention to companies with great track records, especially if the business model seems likely to facilitate further success with little innovation.

I believe **Whitbread** (LSE: WTB), the company behind Costa Coffee and Premier Inn, possesses all of the above qualities. In both its chains, I believe the company has perfected easily repeatable and highly profitable templates that provide caffeine and a good night's sleep to the British public (although not necessarily at the same time!).

Whitbread already commands an impressive empire — there are over 3,000 Costa Coffees worldwide, two thirds of which are in the UK, while there are over 60,000 Premier Inn rooms ready to accept businessmen, families and holidaymakers.

You could be forgiven for presuming that Whitbread is a mature business, unable to grow any further given this incredible scale – but I reckon you'd be wrong.

Investment Thesis

Whitbread is about to launch into another period of rapid expansion between now and 2020. It is aiming to grow to 85,000 Premier Inn rooms. Meanwhile, the target for Costa System Sales (which includes sales from Whitbread-owned stores, franchises and vending machines) is to increase from £1.4bn to £2.5bn.

This ambitious expansion plan will require a tremendous amount of spending, kicking off with predicted capital expenditure of £700m next year. It seems likely that Whitbread is going to have to take on more debt to fund its new coffee shops and hotels, given that it only generated £519m in cash from operations last year.

However, I believe the vast improvement in cash flow that this expansion could generate, if successful, more than outweighs the risk of the company taking on additional debt – and I believe this largely because of the strengths of its key brands.

Costa Coffee is the undisputed king of the UK caffeine-fuelling market, with 50% of customers naming it their favourite coffee shop. Its closest rival in the UK, **Starbucks**, commands less than half the market share of Costa. What's more, Starbucks only managed an operating margin of 3.7% last year compared to Costa's impressive 14%!

The macro-economics of the UK coffee market seem to indicate Costa has plenty of room to grow, too, with the market research outfit IBISWorld expecting it to expand at a compounded annual rate of 5.9% until 2021. Better still, more of us Brits are now buying our favourite coffee daily, instead of as a treat. This has increased the predictability of purchases in any given location, allowing for more efficient supply management and smoother cash flow, two very attractive traits for both franchisees and company-owned stores.

The UK currently consumes a relatively small amount of coffee per capita per year at only 2.8kg. Finland, by way of example, comes in at 12.2kg! While we have clearly not hit peak-caffeine addiction, I don't expect the UK to be swapping tea for espressos any time soon. However, I do believe we will close some of the consumption gap with our American cousins, who consume 4.2kg.

Premier Inn is the largest hotel chain in the UK, and in my view is another smoothly run operation. Not only does it

dominate its mid-budget niche by size, but by customer satisfaction ratings, too. I believe this is linked to its "Great Night's Sleep Guarantee", and the company-owned restaurant brands Beefeater, Brewer's Fayre, Table Table and Taybarns, all of which provide guests with good value food.

Premier Inn has consistently won the Best Value Hotel Chain award from YouGov. Trip Advisor scores speak for themselves as well, clocking in at 4.3 out of 5, and Which? recently named it the top hotel chain in the UK with an 82% positive rating.

Financials And Valuation

Trading on a P/E multiple of 23 times, Whitbread might not seem fantastic value at first glance. However, the rapid expansion the company is going through justifies this rating in my mind. In September, the company confirmed it was on track to hit expectations, and therefore looks likely to earn around 240p per share this year, placing it on a less demanding multiple of 19 times. For a company with such established and defensive brands that's still expanding rapidly, I think this is a reasonable valuation.

Turning from profits to cash, I believe Whitbread could generate somewhere in the region of £850m in cash from operations by 2020, compared to £520m last year, assuming it achieves its growth goals. The company is currently valued at 16 times cash flow, and therefore I believe the company could be valued at around £13.6bn, or 60% higher than it is now once the expansion is complete and if that multiple still applies.

The current annual dividend of £150m should also have ample room to expand given this cash flow growth, and I believe it could double by 2021 if targets are met.

Year ended	1 Mar 2012	28 Feb 2013	27 Feb 2014	26 Feb 2015
Sales (£m)	1,778	2,030	2,294	2,608
Pre-tax profits (£m)	306	343	347	464
Earnings per share (p)	152	166	183	205
Dividend per share (p)	51	57	69	82

Data from S&P CapitalIQ.

Risks

Whitbread's current CEO, Andy Harrison, has announced his retirement plans and will be replaced in early 2016 by Alison Brittain, the current boss of the retail arm of **Lloyds Banking Group**. Inevitably, there might be some concern that the departure of a successful leader could hinder the company's expansion plans, but as I mentioned earlier, I believe the simplicity of replicating the past success of the Costa and Premier brands should mitigate this.

The introduction of George Osborne's Living Wage could significantly increase staffing costs at the company. The company has said it is likely to respond by raising prices and boosting productivity. If wage costs and the cost of other inputs, such as coffee, were to rise violently and simultaneously, this could affect the business more significantly.

When I'd Sell

Interim results released in October said that net debt had increased to £640m. I think this is a comfortable level given the company's current profitability, but it is likely to rise as the company's expansion plan continues to play out. While I believe the cash flow eventually generated from this strategy is worth taking on debt for, if cash from operations did not seem to be rising at the expected pace, I would consider selling.

If Brittain, the incoming CEO, made sweeping changes to the business then I would seriously reconsider my thesis. After all, the elegance of Whitbread rests in its replicable chains – the company does not and should not have to change these formulas drastically to grow.

Disclosure: As at 9 October 2015, Zach owned no shares in any company mentioned above.

The Kraft Heinz Company

"Invest alongside investing giants"

By Nathan Parmelee

Nathan Parmelee

WHAT IT DOES: Kraft Heinz is a global food company selling sauces, beans, meats, cheeses and other snack foods under well-known brand names such as Heinz, Kraft, Amoy, Daddies, Planters and others.

WHY BUY:

1. Backing of Warren Buffett's **Berkshire Hathaway** and consumer brands focused private-equity giant 3G Capital.
2. Substantial margin expansion and international growth potential.
3. Kraft Heinz has the potential to be a platform for 3G Capital and Berkshire Hathaway to make additional acquisitions in packaged foods globally.

KraftHeinz

Market	Ticker	HQ	Website
Nasdaq	KHC	Pittsburgh, USA	www.kraftheinzcompany.com

$90.2 bn	$11.5 bn	$8.9 bn	$74.29
Market Cap	Heinz Net Debt (as at 28 JUN 15)	Kraft Net Debt (as at 28 MAR 15)	Recent Price

Price data as at 9 October 2015

Kraft Heinz

The Kraft Heinz Company (NASDAQ: KHC) isn't your average consumer foods company. It's the recent combination of two giants with some of the best known brands in the world, and more importantly it has the backing of Warren Buffett's Berkshire Hathaway and 3G Capital, two investors with very strong reputations from their success over the years.

About The Company

Up until July of this year, Kraft and Heinz were separate food companies, and each was a giant in its own right with more than a century of history. The recent merger of the two creates a global food giant with unusual growth potential in what is usually a staid industry.

Kraft's historical sales are nearly twice as large as Heinz's, but are lower margin and only in North America. The company is best known for its cheese, and for other pre-packaged foods like macaroni and cheese, but is also the maker of numerous sauces and dressings, and has a large beverage business. Some of Kraft's brands have international growth potential, and I believe Heinz will use its international distribution to selectively expand the Kraft business.

Heinz is a smaller business, but known globally for its ketchup and sauces — and in the UK for its beans, too. Heinz was acquired by 3G Capital and Berkshire Hathaway in 2013, so it comes into the merger leaner and with 3G Capital's well-known cost-cutting and operational controls already in place.

3G is best known for its success with **Anheuser-Busch Inbev,** which is the current incarnation of the global beer giant that started more than a decade and a half ago as Brahma in Latin America. The growth at AB Inbev has come from cost cutting — some would say ruthless cost cutting — that has expanded margins and boosted cash flow. That cash flow is then available to go out and acquire other beer makers that can be put through the same cost reduction and margin expansion process.

Investment Thesis

3G and Berkshire Hathaway are now applying this model to the packaged food industry, and I believe the cost cutting will lead to a significant improvement in margins at Kraft Heinz. AB Inbev is a good example, but 3G has also taken the EBITDA (earnings before interest taxes depreciation and amortisation) margin at Heinz from 18% when the company was acquired in 2013 to better than 25% at the end of 2014. The man behind those improvements, Heinz CEO Bernardo Hees, comes from 3G and will stay on to lead the combined company.

Cost cutting isn't the only growth opportunity at Kraft Heinz. Both 3G and Buffett have said they plan to take a long-term view of the operations at Kraft Heinz, and prior to this deal Heinz has been busy introducing new products — most notably launching a mustard in the US to go along with its namesake ketchup. I believe we'll see more of the same from Kraft Heinz going forward, as well as international expansion of the Kraft business using the distribution platform of Heinz, and I believe that in time Kraft Heinz will be an acquirer in packaged foods, just as AB Inbev is in the beer industry.

Financials And Valuation

The merger of Kraft Heinz was completed on 2 July or just after the second quarter closed. The third-quarter results released in November 2015 will be the first financial statements as one company. The table below provides a summary for the combined businesses that I have compiled.

Year ended 28 Dec	2012	2013	2014	Last 12 Months*
Sales ($bn)	29,800	29,247	29,127	28,450
Operating profits ($bn)	4,695	4,724	4,220	4,159
Net profits ($bn)	2,654	2,306	1,700	1766
Dividend per share ($)	0.50	2.05	2.15	2.20

*Data from S&P CapitalIQ. *Last 12 months to 30 June 2015.*

The sales and profit declines above are less ominous than they might first appear. Sales have trended lower primarily because 3G has been pruning the Heinz brand portfolio since it acquired the company in 2013. It's a similar story for operating profit and net profit, which have declined as Kraft's results include those of Mondelez International for 2012 and 2013. It's also worth noting that Heinz recognised substantial one-off acquisitions costs after being acquired by 3G and Berkshire Hathaway in 2013.

In short, there isn't a pretty historical picture of results from Kraft Heinz, but I think that helps to make the company less well understood.

I prefer the enterprise value-to-EBITDA multiple over the P/E ratio when looking at the valuation of consumer staples companies, because it takes into account the considerable debt these companies often hold. At $75 per share Kraft Heinz trades at approximately 14 times its expected 2016 EBITDA. On the surface this isn't cheap, but it's in the same range as Kellogg, Danone and other consumer giants. The difference is Kraft Heinz is looking at $1.5 billion in planned cost cuts adding 5% or more to its operating and EBITDA margins. Its peers have more conventional growth expectations.

Risks

Prices for grains, proteins and oils are volatile and could rise, making it more difficult for Kraft Heinz to achieve margin improvements. However, Kraft Heinz's gross and operating margins are well below those of its competitors, so I believe the company can make improvements that get it on par with the competition even if commodity prices become a challenge.

While Heinz brings an international distribution platform to the pairing, it is still possible that not enough of Kraft's products will resonate overseas and materially contribute to growth. I think 3G's experience and international background will help them adapt products and marketing messages to different markets, but it's still possible that international growth could prove challenging.

Do bear in mind that if you buy any US dollar-denominated share, you take on a currency risk. The value of your dollar investment may reduce in sterling terms if the pound strengthens.

When I'd Sell

A final risk to the thesis is that 3G's cost-cutting strategy could lead to low morale and poor execution. If I saw this unfolding, I would consider selling. If 3G ran into morale problems at AB Inbev or Heinz, then it seemingly wasn't enough to keep it from succeeding at dramatically improving the profitability of these businesses, so I think it's unlikely it will stumble now. Still, given 3G's strategy, I think it's something to keep an eye on.

Disclosure: As at 9 October 2015, Nathan owned shares of Berkshire Hathaway and Mondelez International, but did not own shares in any of the other companies mentioned.

Vectura Group

"Hidden growth in out-of-favour industry"

By Mark Stones

Mark Stones

WHAT IT DOES: Vectura Group develops therapies for asthma and smoker's cough, which is a market estimated to be worth $44bn.

WHY BUY:

Maiden after-tax profit could herald a phase of growth.

Niche therapeutic areas offer attractive self-commercialisation opportunities.

Biotech shares are going through a rough patch – potentially creating significant upside

Market	Ticker	HQ	Website
Main	VEC	Wiltshire	www.vectura.com

£198 m	£90 m	161.7 p
MARKET CAP	Net Cash (as at 31 MAR 15*)	Recent Price

Price data as at 9 October 2015

Vectura Group

About The Company

Vectura Group (LSE: VEC) is a pharmaceutical company that develops products for airway-related diseases. Specifically, Vectura's big areas of focus are asthma and COPD (smoker's cough), which are estimated to affect at least half a billion people worldwide. Its reputation in this area appears to be strong, with the company claiming to be the "partner of choice" in developing respiratory products.

The majority of Vectura's sales are from royalties, and it has eight products that are marketed by blue-chip partners including **GlaxoSmithKline** and **Novartis**. In its latest financial year, royalty income increased by 55%, which I reckon helps to validate both Vectura's business model and the quality of its patented technology.

Investment Thesis

There is no known cure for COPD, and more people are becoming sufferers each year. By 2025, the World Health Organization forecasts that 100 million more people could be affected by the condition.

Two of Vectura's major products, Ultibro and Seebri (which deliver inhaled powder formulations to patients once-daily), are being marketed by Novartis. They have made their way into 140 countries, up from 90 in the previous year, delivering significant royalties for Vectura.

The recent success of the royalty model – in 2015 the company delivered its maiden after-tax profit, and posted positive operating cash flow for just the third time in its history – has led to the company deciding to build on its current strategy.

Vectura is looking to commit additional capital and make more co-development deals, meaning it would not only be responsible for the pharmaceutical development of new products, but it would also have to see products through the clinical and regulatory side.

Vectura believes that by committing additional resources, it should receive higher commercial rewards from its products. This could mean taking the self-commercialisation route, in niche therapeutic areas such as chronic cough or uncontrolled severe asthma – where there is significant unmet medical need.

The company first revealed this shift in strategy in 2014, and has stated that "prudence" is the order of the day. That means it has to be cost effective – niche products where only a small sales and marketing infrastructure are required is the area Vectura believes it could create further value.

Overall, I think that Vectura is in an attractive place now. Its COPD medications have been "proven to reduce exacerbations" to a far greater extent than competing treatments. It's an encouraging sign, and could mean its large royalty streams are sustainable. Meanwhile, if Vectura can successfully become a niche specialty pharmaceutical business, and achieve even greater cash flows than at present then, in my opinion, the shares look undervalued.

Financials And Valuation

Shares in the pharmaceutical and biotech industry have sold off recently in response to a political backlash against "price gouging". This was after news that a former hedge fund manager, Martin Shkreli, had hiked the price of an old HIV drug by 5,000%. Or it might be that growth stocks, like Vectura, are out

of favour, with investors deciding that they've been paying too much and seeking better value elsewhere.

Despite recent falls, shares of Vectura are still on a P/E multiple of 42. My estimate of the company's intrinsic value, however, indicates that the company may be underpriced. I value Vectura at between 211p to 235p per share, which could provide an upside of 30% to 45% from today's prices.

Year ended 31 March	2012	2013	2014	2015
Sales (£m)	33	31	37	58
Pre-tax profits (£m)	(13)	(10)	(2)	(6)
Adjusted eps (pence)	(3)	(2)	(1)	1
Dividend per share (pence)	-	-	-	-

Data from S&P CapitalIQ.

Risks

Let's make no mistake, this is a high-risk investment idea, and before buying I would encourage you to think very sensibly about sizing this position appropriately within a larger portfolio.

There are several assumptions in my model, and if we were to see competitors overtake Vectura's technology then my valuation could prove optimistic. The company's product pipeline must deliver – if it doesn't, then Vectura won't deliver the sustainable cash it needs to fuel its growth, hurting my investment thesis.

Fortunately, there is £90m of cash on the company's balance sheet, and no debt, meaning the company should have the flexibility to pursue its goals. The company might make acquisitions to bolster its pipeline, but I'd be wary if these became excessive, and weakened the balance sheet position with acquisition-related debt.

Also, a large proportion of Vectura's income is received in US dollars and Euros, although the company reports in pounds sterling. So future currency movements might pose a risk to earnings.

When I'd Sell

I would be paying attention to R&D expenditure, and if there are signs that this area is becoming less of a priority – for example, if spending fell below £30m for consecutive years without a good reason – then I'd consider heading for the exit.

I'm betting on a company that I think is an innovator, so R&D is an essential component. I certainly wouldn't consider selling if the sector became temporarily out of favour – much as I think it is now – and the share price declined for reasons that were nothing to do with its own business performance.

If you're a Foolish investor, then keeping a check on your emotions and riding out volatility is a fundamental trait.

Disclosure: As at 9 October 2015, Mark owned shares in GlaxoSmithKline but in no other company mentioned above.

Cambria Automobiles

"Driving shareholder returns"

By Michael Olsen, CFA

Michael Olsen

WHAT IT DOES: Cambria Automobiles operates car dealerships and associated service centres, as the owner of 29 dealers representing 17 brands.

WHY BUY:

1. Car dealerships benefit from sizable, underappreciated competitive advantages.
2. Cambria's strategy—acquiring underperforming dealerships—affords sizable growth potential in the fragmented UK car dealership market.
3. Founder and owner-operator CEO Mark Lavery owns 40% of Cambria, and has proven to be an excellent steward of capital.

CAMBRIA Automobiles plc

Market	Ticker	HQ	Website
AIM	CAMB	Swindon	www.cambriaautomobilesplc.net

£67.5 m	£0.9 m	68 p
Market Cap	Net Debt (as at 28 FEB 15)	Recent Price

Price data as at 9 October 2015

Cambria Automobiles

The best investment ideas frequently don mundane garbs. Take car dealerships. On a cursory review, many investors would assert they resemble retailers: cyclical, competitive businesses with few enduring advantages. But appearances can deceive. On careful examination, it becomes apparent dealerships benefit from substantial moats and fairly recurrent cash flow.

Nevertheless, car dealers continue to fetch pedestrian valuations. For would-be investors in **Cambria Automobiles** (LSE: CAMB) — an operator of 29 car dealerships spanning 17 brands — that's not so bad.

This seemingly high-quality business run by an operations-savvy, value-focused founding management team trades for 11 times forecast earnings — a meagre valuation, in my opinion. By my maths, Cambria's potential for double-digit earnings growth comes at little cost. That's why I'm recommending you test drive, and take home, shares of Cambria Automobiles.

About The Company

Cambria's strategy — to acquire and improve underperforming independent car dealerships — should resonate with value hounds. Helmed by chief executive Mark Lavery, who owns 40% of the company's shares, Cambria represents the cream of British entrepreneurship — an incentivised founder with 20 years' experience.

My interest derives from this, and what I believe is a less appreciated fact. Historically, car manufacturers have limited the number of franchise rights — the ability to operate a new car dealership — in a given area. This limits competition, conferring local monopolies or oligopolies unto new car dealers. Incumbents of scale, like Cambria, benefit accordingly. Its largest brands, by number of locations, are Volvo, Jaguar, Fiat, Ford, Mazda and Aston Martin, and its footprint skews towards the wealthier south-east.

Over the years, management has carefully honed its buy-and-improve strategy. Cambria systematically deploys industry best practices at recent acquisitions — on inventory management, compensation practices, and use of information technology — in pursuit of improved profitability. Acquired targets benefit from Cambria's scale in lower borrowing costs, sharing select corporate functions, purchasing and inventory management.

The results are impressive. Of the 11 acquired dealers since inception, only two were profitable at the outset. Even so, management has consistently delivered mid-teens returns on equity, and consistently improving profitability.

Investment Thesis

The popular perception is that dealers make the bulk of their money selling cars. In fact, car sales are a precursor to a more profitable revenue stream: service contracts. Where new and used cars earn about 6% and 10% gross margins, well-oiled service departments can earn gross margins above 50% and afford a stable, recurring and high-margin cash flow.

Parts and service represent 12% to 15% of sales for Cambria, but 40% of gross profits.

Historically, revenue from warranty servicing follows new car sales. On this count, Cambria should benefit from UK new car sales' strength, recently registering multi-year highs at 2.5 million vehicles per annum. Cambria has grown new car sales at a 10% annualised rate for three years — positioning Cambria's aftersales revenues to grow at mid- to high-single digit rates for three to four years, by my maths. As higher-margin service revenues trickle through, profits should turn northward.

Likewise, I believe considerable potential for operational improvements remains. A well-oiled dealership can generate 2.5% to 3% operating margins. Pendragon, the largest UK dealership by volumes, generates 2.3% operating margins, and Lookers — the third largest — has managed operating margins above 2%. Cambria's trailing operating margins, by comparison, sit at 1.5%.

I also expect Cambria's management to continue its successful practice of buying and improving struggling dealers on the cheap. According to a recent Edison Investment Research report, the top 10 UK auto dealership groups comprise only 20% of the market. For Cambria's management — which targets £1 billion sales in the medium term, against trailing 12-month sales of £485 million — that's a huge opportunity.

Financials And Valuation

Across the next five years, I expect Cambria to grow revenue 8% to 10% from increased service revenue from recently sold vehicles, a stable level of new vehicle sales, and ongoing acquisitions. While some analysts worry that new car sales' recent trend is unsustainable, I'd contend otherwise — they're fairly consistent with pre-credit crisis averages, and the UK vehicle stock has aged considerably over the past five years.

I expect operating margins to approach 2% in three to five years. Underlying this is a growing proportion of more profitable service revenues, improved profitability within service operations (which lag peers) and declining operating expenses relative to revenue from operational improvements and scaling of fixed costs.

On this basis, I value Cambria shares near 100p — almost 50% upside from their position at the time of writing.

Year ended 31 Dec	2011	2012	2013	2014
Sales (£m)	374	353	396	450
Pre-tax profits (£m)	4.9	3.1	4.1	5.4
Adjusted eps (pence)	3.2	2.6	3.6	4.2
Dividend per share (pence)	0.3	0.3	0.5	0.6

Data from S&P CapitalIQ.

Risks And When I'd Sell

Chief among the risks to Cambria is a slowing economy and lower sales volumes. I'd expect any declines to be cyclical, and relatively short-lived. These risks are somewhat mitigated by the ballast from parts and services revenue.

Because Cambria's strategy pivots around acquiring under-performing dealers, a botched deal — or overpaying — is an ever-present risk. Though management's track record is stellar, it bears watching.

Last, Cambria's CEO or CFO — both instrumental figures — could leave. Without a credible succession plan, I'd consider selling. Acknowledging Lavery's 40% ownership, this risk seems negligible.

In conclusion, Cambria epitomises my favourite qualities in small-cap investments — an incentivised and capable CEO, underappreciated competitive advantages, and still unrecognised and large growth prospects. At a humdrum 11 times forecast earnings, Cambria shares might offer an exhilarating ride.

Disclosure: As at 9 October 2015, Mike did not own shares in any company mentioned above.

Arbuthnot Banking Group

"How to enjoy 'free' banking"

By Owain Bennallack

Owain Bennallack

WHAT IT DOES: Arbuthnot Banking Group is a holding company comprising private bank Arbuthnot Latham and a stake in Secure Trust Bank, a retail bank.

WHY BUY:

Discount to sum-of-parts valuation.

Favourable climate for challenger banks.

Expansion at Arbuthnot Latham.

ARBUTHNOT BANKING GROUP PLC

Market	Ticker	HQ	Website
AIM	ARBB	London	www.arbuthnotgroup.com

£220 m	N/A	1,475 p
Market Cap	Net Debt	Recent Price

Price data as at 9 October 2015

Arbuthnot Banking Group

About The Company

Just like with taxi drivers in the wilder corners of the globe, longevity is nice to see in financial services. And with roots going back to 1833 with the founding of Arbuthnot & Latham in London, the **Arbuthnot Banking** (LSE: ARBB) brand has been around for 188 years, financing everything from coffee plantations to gold mines, and surviving the destruction of its head office in the Blitz.

Arbuthnot Latham was floated on the London Stock Exchange in 1960. As usual with these age-old bank names, growth has been accelerated with mergers and acquisitions along the way, as well as changes of brand and ownership.

Today's Arbuthnot Banking Group comprises the private bank Arbuthnot Latham & Co and a controlling stake in a fast-growing retail bank, **Secure Trust Bank** (LSE: STB).

Investment Thesis

I believe an investment in Arbuthnot Banking Group enables you to participate in the recovery of the banking sector without the burden of legacy issues that dog the major high-street brands. Even better, it enables you to do so at a discount, because in my opinion the combined value of the two banks it owns is not reflected in the group's share price.

Arbuthnot Banking owns a 51.92% stake in its subsidiary, Secure Trust Bank. With Secure Trust Bank currently trading at 2,870p a share, that's worth around £270m. Yet the market capitalisation of Arbuthnot Banking Group is only £220m.

This means on one interpretation, the Arbuthnot Latham & Co private banking unit is valued at minus £50m!

Of course, that is not the only way to rationalise this apparent discrepancy. You might argue the sheer size of the Secure Trust Bank stake means it deserves to be valued at a discount, because Arbuthnot Banking Group can probably not dispose of it without adversely affecting its price.

That's fair, although in June 2014 when Arbuthnot last sold a major chunk of Secure Trust Bank – 1,041,667 shares to be exact, reducing its stake from 67% to 53.25% – it placed the shares with institutional investors at 2,400p, which was a discount of just 4% to the price then prevailing. But even applying a higher 10% discount to today's stake only reduces its value to £243m, which still leaves Arbuthnot Banking Group valued at less than its Secure Trust Bank shareholding.

Is Arbuthnot Latham and Co such a terrible business it can be considered as destroying value? I don't believe so.

Financials And Valuation

Often when faced with an apparent valuation discrepancy, an investor needs to look through some terrible short-term figures to ultimately profit from hidden value.

However, that doesn't seem to be the case here, with profits for the group growing strongly:

Year ended 31 Dec	2011	2012	2013	2014
Net interest income (£m)	39.2	62.3	93.3	117.6
Pre-tax profits (£m)	5.1	12.6	15.7	22.5
Adjusted eps (pence)	35	53	52	56
Dividend per share (pence)	24	25	26	27

Data from S&P CapitalIQ.

Interim results showed this trend continuing, with first-half pre-tax profits at Arbuthnot Banking Group up to £15.7m and earnings per share 68% higher at 42.4p. Average analyst forecasts

of 97.5p for the full year look achievable to me, equating to a P/E of 15, falling to around 11 on next year's forecasted earnings of 130p. This seems good value for a growing business.

Profit growth to date has been dominated by the rapid expansion at Secure Trust Bank, but I believe Arbuthnot Latham should contribute more in the future. First-half profits at the private bank more than doubled to £3.7m, thanks to increased staff and offices, and the acquisition of a portfolio of residential mortgages. According to management the bank's new Dubai office was on track to achieve break-even in the second half, too, which means it should also start contributing to growth.

Expanding profitability at Arbuthnot Latham reduces the risk that the valuation gap I've identified is justifiable. Arbuthnot Banking Group lumps certain operating expenses under what it calls "Group Centre", which includes costs arising from both Arbuthnot Latham and Secure Trust Bank. In 2014, Group Centre reduced Arbuthnot Banking Group profits by around £7.5m – or more than double the £3.6m profits achieved that year by Arbuthnot Latham.

However, profits at Arbuthnot Latham back in 2013 were nearer £8m, and we've seen from the interims that the private bank has recovered in the current year, too. The half-year profits at Arbuthnot Latham of £3.7m compare pretty well to interim Group Centre costs of £4.1m, not all of which will be due to the private bank.

Rather than risk trying to be more precise than is possible, I simply estimate that at today's rate of profitability, Arbuthnot Latham's share of Group Centre costs are covered. Thus I feel this private banking business is worth more than nothing (as opposed to minus £50m) and so that the sum-of-the-parts discount I identified in my investment thesis represents genuine value.

Risks

The PPI scandal (which has already cost high-street banks in excess of £20 billion) serves warning that bad practices at banks can have hugely damaging consequences. More subtly, legitimate yet overly aggressive lending can be hard to spot in the good times. While as best I can tell activities at Arbuthnot Latham and Secure Trust Bank acceptably balance risk and return, there is always a danger that bad debts or future legal liabilities are being stored up that aren't yet apparent.

As we saw in the last decade, even the best banks can be hit when a financial hurricane strikes. I believe the financial system is in a much stronger position than before the last crisis. However, those who do not learn from history are doomed to repeat it, so I would be alert to any emerging stresses in the system or to what I perceived to be an undue increase in risky lending practices in the sector.

When I'd Sell

The most obvious reason to sell would be when the value I see has been realised. This could come about because the share price no longer discounts the sum of the parts, or because those parts have been torn asunder – that is, because Arbuthnot Banking Group's controlling stake in Secure Trust Bank has been sold or perhaps spun off to shareholders.

On the other hand, if Arbuthnot Banking's management explicitly stated the stake in Secure Trust Bank would never be disposed of, I'd rethink my investment. I wouldn't necessarily sell, but I would want to feel holding on was attractive even without the potential of a value-outing restructuring.

Disclosure: As at 9 October 2015, Owain owned shares in Arbuthnot Banking Group.

Northgate

"Hire returns for your portfolio"

By James Early

James Early

WHAT IT DOES: Northgate is the market leader in flexible commercial vehicle hire in the UK and Spain.

WHY BUY:

Strong dividend that rose 45% in 2015.

Significant recent investment beginning to pay off.

Poor 2015 share price performance gives buying opportunity

NORTHGATE

Market	Ticker	HQ	Website
Main	NTG	Darlington, County Durham	www.northgateplc.com

£550 m Market Cap

£340 m Net Debt (as at 30 APR 15)

414 p Recent Price

Price data as at 9 October 2015

▶ ***Northgate***

About The Company

Northgate (LSE: NTG), which began as Noble Self Drive in 1981, hires out light commercial vehicles. They're mostly vans and cars weighing less than 3.5 tonnes, and they're hired out in the UK, Ireland and Spain.

I'll admit it: vehicle hire is as unglamorous as an industry gets. But we don't buy shares for glamour (at least sensible people don't), we buy them to make profits. And that Northgate does quite well.

Returning to the details, turnover is split roughly 70%/30% between the UK and Spain. In the UK, Northgate has roughly 50,000 vehicles for hire, and customer numbers have been growing by roughly 7% a year. Spain is a newer market, with a fleet of 36,000 vehicles and it is seeing customer growth of 22% a year. Northgate boasts greater than 20% market share in both regions.

The company's customers are primarily businesses – generally small- to medium-sized enterprises. Conceptually, these customers can meet their marginal vehicle needs on a spectrum ranging from outright purchase at one end and daily hire on the other. Northgate's "flexible rental" programme is in the middle of that offering spectrum.

Being a middle-ground solution saves Northgate the hassle, and renters the cost, of renting daily while still affording flexibility for both commitment-phobes and smaller, growing businesses that don't quite know their long-term vehicular needs yet.

No upfront capital is required from renters, and Northgate does the maintenance on the vehicles. Once they're deemed past their prime, it sells them (its average vehicle age being 21 months).

Investment Thesis

I love a good bargain, so the fact that Northgate's shares were soft in 2015 stirs interest — cautious interest, but interest nonetheless — within my thrifty soul. And as I researched more, I came to believe that the best days for Northgate and its shares may lie ahead.

After roughly a decade of increasing investment, Northgate's Spanish operations are making a solid profit, with room still to grow in my view. New sites generally become profitable for the company after two years; their returns on equity begin to level off after four.

As Northgate's Iberian margins ripen, the company expects its 17% operating profits margin there to rise to 23%, which is in the neighbourhood of its UK business. And after years of what may be politely termed a rather sluggish state, Spain's economy may be readying to regain a modicum of momentum.

Speaking of growth, Northgate has added 15 sites to its UK base over the past two years, taking it to 75, with another 14 bases slated over the new few years.

Overall, turnover has been growing in both markets – 10% a year in aggregate – with profit growth not far behind. Vehicles for hire have also been increasing at 10% a year. Northgate has hit its business stride by directly targeting smaller enterprises and taking various steps to improve their loyalty.

Financials And Valuation

The past five years, during the reign of now-erstwhile chairman Bob Mackenzie, have seen big gains in profit, a reduction in the level of debt (specifically, he reduced gearing from 232% five years ago to near 80% now) and reintroduction

of the dividend. In fact, Northgate's dividend grew by 45% in 2015. Yet the company keeps cover high, at 2.5 – 3.75 times.

I'm conservative in my modelling – or at least I'd like to think I am – and project no profits growth for the next few years. I feel my 10.5% equity discount rate is middle-of-the-road and fair for Northgate, whose share price my model reckons should rightfully be north of 600p.

Year ended 30 Apr	2012	2013	2014	2015
Sales (£m)	707	610	571	614
Pre-tax profits (£m)	46	50	60	83
Adjusted eps (pence)	30.4	29.2	35.1	50.1
Dividend per share (pence)	3.0	7.3	10.0	14.5

Data from S&P CapitalIQ.

Risks

One risk is new management: the passing of the torch from Bob Mackenzie to new chairman Andrew Page invariably brings new ideas, priorities and ways of doing things.

Another is that vehicle hire has somewhat low barriers to entry. I'm not worried about some upstart hiring out a few vans; any serious entrant would need adequate capital to negotiate volume discounts to rival market leader Northgate. But a well-funded entrant specifically targeting this sphere would worry me.

More ordinary but no less important are risks like a soft economy or poor selling prices for used cars; as much as 30% of Northgate's turnover can come from peddling its bygone wheels. But it's also true that a slow economy may tip more would-be buyers towards hiring, and a weak car market could mean lower purchasing prices for Northgate's new fleet as well.

When I'd Sell

Northgate is close to a no-thesis share (my favourite kind). It needs only to continue apace, with no major catalyst, intervention or contingency required for the investment to meet my expectations.

The first two risks above may be 'sell' catalysts if present to a large enough degree – botched management or a powerful competitor. But fortunately – at least I hope – neither is likely. More probable, in my view, is that Northgate continues to grow its boring but steady car hire business, quietly enriching shareowners all the way.

Disclosure: As at 9 October 2015, James held no position in any company mentioned above.

Risk Warning

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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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