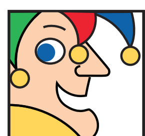
# SHARES 2017

## SEVEN TOP IDEAS FOR THE YEAR AHEAD



The Motley Fool

To Educate, Amuse & Enrich™

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# Introduction

What a year 2016 has been. On 23 June, Britain voted to leave the European Union — and this sent shockwaves throughout the financial markets… for a few days, at least.

The stock market is more than capable of making a mockery of 'conventional wisdom', and strongly rallied in the aftermath of the Referendum, leaving most market commentators and pundits red-faced.

Very few people expected Brexit to be the outcome. Even fewer imagined that a win for "Leave" would send the FTSE 100 to a new all-time high.

How about us, here at The Motley Fool? I'd love to say we knew what would happen, but we did not. In fact, as usual, we made no attempt to guess. Here's what I wrote in the introduction to Shares 2016 at this time last year:

> *"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****."*

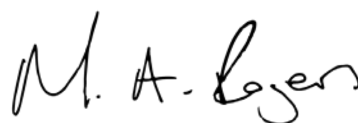
Our message to members in the wake of the Brexit vote was to "Keep Calm and Carry On" — to avoid making rash decisions in the face of market turmoil. It's in such volatile conditions that we tend to make the greatest mistakes in the stock market. Investors who were prepared, and held onto their investments, probably fared the best this year. Those who sold the lot on the morning of 24 June, I would imagine, regret missing the rally that followed…

The coming year will likely see Article 50 triggered, and the consequences of a weaker pound (and perhaps higher inflation) could also be revealed. Meanwhile, over in the US, President Trump could be making policy changes that will have implications for the global economy. However, this message that I included in last year's Shares reports still sums up the approach we think investors should take:

> *"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 2017: 7 Top Stocks for the Year Ahead*. Inside these pages, you'll find **seven long-term investment ideas** — shares that we believe aren't just great for 2017, but could be superb buy-and-hold investments for years to come.

No matter what the year ahead brings, we hope this report prepares you well.



**Mark Rogers**
*Head of UK Investing,*
*The Motley Fool UK*

# The Story So Far

## *Shares 2010 through to Shares 2016*

### Shares 2010

| Company | Return |
|---|---|
| PV Crystalox Solar (LSE: PVCS) | -33.9% |
| Nautical Petroleum (LSE: NPE) | 643.8% |
| Goodwin (LSE: GDWN) | 142.8% |
| Charlemagne Capital (LSE: CCAP) | 18.7% |
| Tesco (LSE: TSCO) | -38.8% |
| GlaxoSmithKline (LSE: GSK) | 97.0% |
| Hansard Global (LSE: HSD) | 13.4% |
| Healthcare Locums (LSE: HLO) | -100.0% |
| National Grid (LSE: NG) | 188.7% |
| Telecom Plus (LSE: TEP) | 438.1% |
| **Total Return** | **137.0%** |
| **Return v FTSE All-Share Total Return Index** | **52.0%** |

### Shares 2011

| Company | Return |
|---|---|
| GKN (LSE: GKN) | 119.4% |
| Halfords (LSE: HFD) | 14.7% |
| McKay Securities (LSE: MCKS) | 99.4% |
| Mothercare (LSE: MTC) | -70.6% |
| NCC (LSE: NCC) | 188.7% |
| Smith & Nephew (LSE: SN) | 130.8% |
| Velosi (LSE: VELO) | 61.0% |
| **Total Return** | **77.6%** |
| **Return v FTSE All-Share Total Return Index** | **20.5%** |

### Shares 2012

| Company | Return |
|---|---|
| Sports Direct (LSE: SPD) | 8.2% |
| Reckitt Benckiser (LSE: RB) | 150.6% |
| Halma (LSE: HLMA) | 210.3% |
| Timeweave (LSE: TMW) | -5.4% |
| BAE Systems (LSE: BA) | 116.3% |
| Camellia (LSE: CAM) | -9.0% |
| CSF (LSE: CSFG) | -98.0% |
| KCOM (LSE: KCOM) | 107.2% |
| **Total Return** | **60.0%** |
| **Return v FTSE All-Share Total Return Index** | **11.4%** |

### Shares 2013

| Company | Return |
|---|---|
| Moss Bros (LSE: MOSB) | 114.5% |
| McDonald's (NYSE: MCD) | 48.0% |
| National Grid (LSE: NG) | 80.4% |
| Invensys (LSE: ISYS) | 61.9% |
| Tasty (LSE: TAST) | 193.4% |
| Admiral (LSE: ADM) | 132.4% |
| Daily Mail (LSE: DMGT) | 53.9% |
| Premier Oil (LSE: PMO) | -77.8% |
| **Total Return** | **75.8%** |
| **Return v FTSE All-Share Total Return Index** | **33.4%** |

## Shares 2014

| Company | Return |
|---|---|
| Reckitt Benckiser (LSE: RB) | 61.7% |
| TT Electronics (LSE: TTG) | -20.4% |
| Cohort (LSE: CHRT) | 65.6% |
| Greggs (LSE: GRG) | 147.4% |
| J. Smart (LSE: SMJ) | 24.2% |
| Rexam (LSE: REX) | 40.1% |
| Blackhawk (NASDAQ: HAWK) | 59.1% |
| **Total Return** | **54.0%** |
| **Return v FTSE All-Share Total Return Index** | **35.1%** |

## Shares 2015

| Company | Return |
|---|---|
| Rolls Royce (LSE: RR) | -6.4% |
| Skyepharma (LSE: SKP) | 24.3% |
| Bodycote (LSE: BOY) | 2.9% |
| Mincon (LSE: MCON) | 44.4% |
| Melrose (LSE: MRO) | 271.3% |
| Porvair (LSE: PRV) | 57.1% |
| Abcam (LSE: ABC) | 108.1% |
| **Total Return** | **71.7%** |
| **Return v FTSE All-Share Total Return Index** | **58.1%** |

## Shares 2016

| Company | Return |
|---|---|
| Ted Baker (LSE: TBK) | -10.1% |
| Whitbread (LSE: WTB) | -15.7% |
| Kraft Heinz (NASDAQ: KHC) | 21.3% |
| Vectura (LSE: VEC) | -18.3% |
| Cambria Automobiles (LSE: CAMB) | -13.4% |
| Arbuthnot Banking (LSE: ARBB) | 19.6% |
| Northgate (LSE: NTG) | 7.8% |
| **Total Return** | **-1.3%** |
| **Return v FTSE All-Share Total Return Index** | **-15.4%** |

**Notes on the calculation of returns**

All returns are measured from mid-price to mid-price and include reinvested dividends but no trading costs.

- Shares 2010 returns are measured from 5 November 2009 to 21 October 2016. 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 21 October 2016. Velosi was taken over and delisted on 26 January 2011.
- Shares 2012 returns are measured from 7 February 2012 to 21 October 2016. Timeweave was taken private and delisted on 13 November 2012.
- Shares 2013 returns are measured from 30 November 2012 to 21 October 2016. Invensys was taken over and delisted on 16 January 2014.
- Shares 2014 returns are measured from 29 November 2013 to 21 October 2016. Rexam was taken over and delisted on 29 June 2016.
- Shares 2015 returns are measured from 28 November 2014 to 21 October 2016. Skyepharma merged with Vectura on 10 June 2016.
- Shares 2016 returns are measured from 9 October 2015 to 21 October 2016.

# Greggs

## "A tasty treat for income-focused investors"

by Mark Rogers

### What it does

Greggs is the UK's leading bakery chain, famous for its sausage rolls and other tasty treats.

### Why buy?

- Seemingly solid business with a fantastic track record.
- Same-store-sales have been on a roll.
- 3.5% dividend yield that should grow from here.

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main, UK | LSE: GRG | Newcastle | www.greggs.co.uk |

| Market cap | Net cash | Recent price |
|---|---|---|
| £990m | £35m | 984p |

*Price data taken on 21 Oct 2016, net cash as at 02 Jul 2016*

### About the company

**Greggs** (LSE: GRG) has always been one of my guilty pleasures.

Famous for its sausage rolls… steak bakes… bacon sandwiches… doughnuts… cheese and bacon wraps… gingerbread men… thick chocolate cookies straight from the oven…

(Is it lunchtime yet? I've suddenly lost my train of thought…)

But it's not just the abundance of low-priced tasty treats that have me daydreaming over Greggs today. I've been a Greggs shareholder for many years, and have long appreciated its delicious, hearty dividends, which have almost tripled over the last decade.

Like-for-like sales have been on a roll since Chief Executive Roger Whiteside was appointed in 2013 and the company launched its "Always Fresh, Always Tasty" food-on-the-go strategy.

With a revitalised menu that Greggs is constantly tweaking to test the interest of British taste buds (onion bhaji burrito, anyone?), the company is back in 'growth mode' and has resumed its store expansion programme.

This well-run British enterprise has an excellent track record of delivering shareholder returns, and with no debt and £35m in cash, its 3.5% dividend yield looks appetising.

### Investment thesis

The original Greggs bakery was founded in 1939 by John Gregg, and the company has steadily grown from a single store to over 1,700 shops up and down the country today. It has nine regional bakeries, and a brand new state-of-the-art distribution centre in Enfield.

It's hard to overstate the popularity of Greggs among British consumers, especially in the northern town where I grew up, and the many others like it. Its outstanding value and no-frills, hearty comfort food has made Greggs a truly loved British brand. Whether you love it or loathe it personally, against a backdrop of constrained household incomes in the last decade, it's not hard to see why Greggs has become so popular.

But there's a lot more to Greggs than its humble image. While the company has at times been considered an underdog for its unpretentious beginnings, its impressive integrated supply chain and considerable freehold estate give the company a significant advantage. To emphasise its position in the market, Greggs has 40% more stores in the UK than global giant McDonalds.

Greggs has impressive scale in many other ways as well — it employs 20,000 people and sells more than 1 billion items each year. It makes 16,000 miles' worth of its famous sausage rolls at a rate of 37,000 rolls per hour in its Balliol bakery near Newcastle. All of Greggs' products are delivered fresh to its stores each day. By 2am the trucks are on the roads, and the food is delivered to shops by 5am, in time for the shops opening at 6am.

As Tesco and other fast-food outlets have discovered, competing with Greggs can be very challenging — its integrated supply chain makes Greggs virtually unrivalled for value, freshness and convenience. Greggs has seemingly mastered the art of supplying and selling traditional baked food at a low price — and if the queues outside its shops at lunchtime are anything to go by, consumers have voted with their feet.

The company isn't resting on its laurels either. Greggs has recently announced it will trial a home delivery service "Greggs Delivered" — supplying your favourite Greggs treats directly to your door. This initiative should roll out in Newcastle, central London and Manchester in the near future. I'm looking forward to trying it out myself (purely for research purposes, of course).

I believe that Greggs can continue to appeal to British consumers, and can increase its store count to two thousand by 2020, in line with the company's internal targets — growing its sales, profits and dividends along the way.

## Financials and valuation

Greggs is valued at just under £1bn by the market, and earned £76m in pre-tax profits last year. The company is on track to earn £82m this year, and I believe it can make £90m in 2017 from a combination of new store openings, increased efficiencies and same-store sales growth.

The company has been reducing its overheads in recent years, consolidating its supply chain to focus on the most efficient bakeries. This has seen operating margins increase from 5.8% in 2013 to 9.1% last year, and I think there could be more improvement to come on this front.

Greggs' operating margins have also benefited from a significant reduction in commodity prices since 2012 (most notably wheat). This continues to benefit the company's profits, although I'm mindful that this could potentially reverse, and may be affected by imported inflation from a weaker pound.

While I don't believe Greggs is dramatically undervalued by the market, I value the company at closer to £1.2bn, which still offers decent upside. Importantly, I believe Greggs' current dividend level is sustainable, and has the potential to grow in the years ahead — offering an attractive income opportunity for investors, backed by a strong balance sheet with no debt.

| Year ended 2 Jan | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|
| Sales (£m) | 735 | 762 | 806 | 836 |
| Pre-tax profits (£m) | 51 | 44 | 62 | 76 |
| Adjusted eps (p) | 39 | 24 | 37 | 56 |
| Dividend per share (p) | 19.5 | 19.5 | 22.0 | 28.6 |

## Risks and when I'd sell

Greggs has enjoyed terrific growth in the last two decades, and after stumbling a couple of years ago, looks to be back on track under Roger Whiteside's leadership — with sales, profits and dividends on the rise recently.

Of course, the company is not immune to external conditions. Greggs' much-improved margins could come under threat if there is significant commodity price inflation in the years ahead, or if other cost pressures arise, such as higher wages or fuel prices. All of these factors have been relatively kind to Greggs in recent years, but I'd be mindful of this risk in the future.

Also, while Greggs is in an enviable market position resulting from its impressive supply chain and distribution network, it'd be foolish — with a lower case 'f' — to discount the possibility of competitive pressures from supermarkets and other rivals in the future.

### Sources

- *Greggs annual reports and presentations on http://www.greggs.co.uk*

### Disclosure

- *As of 21 October 2015, Mark owned shares in Greggs.*

# Sage Group

## "A UK technology gem"

by Mark Stones

### What it does

Sage develops and supplies business and accounting software for small-to-medium sized companies.

### Why buy?

- Business generates significant free cash flow.
- New subscription products should see long-term earnings growth.
- Dividend expected to grow in line with earnings.

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main, UK | LSE: SGE | Newcastle | www.sage.com |

| Market cap | Net debt | Recent price |
|---|---|---|
| £7.8bn | £404m | 722.5p |

*Price data taken on 21 Oct 2016, net debt as at 31 Mar 2016*

### About the company

**Sage** (LSE: SGE) is an accounting and payroll software specialist. The company was founded in 1981, and since then has amassed six million customers in 23 countries.

UK investors certainly aren't spoilt for choice for ways to gain exposure to the global software industry. But Sage appears to be one of the few British software companies that competes on the world stage, and I think it's a real gem. Sage's business has proven durable over the years, and I reckon that should continue as the company modernises.

Not every firm can keep up with changing technological trends. Software is a cut-throat business, so it can be a hard sector for investors to make money in, since it's so prone to disruption. But Sage is doing a good job convincing investors it has a place in the modern computing environment, and I'm particularly impressed by the growth of its cloud platform.

Why is Sage so integral to its customers? Smaller businesses typically don't focus on admin matters or technology, so Sage can help them increase their productivity. Sage's tools automate processes around payroll and accounts and, as you might imagine, no small business owner wants to deal with heaps of paperwork. Installing Sage's products means entrepreneurs can spend less time keeping on top of accounts, and more time innovating and serving their customers.

### Investment thesis

I tend not to like investing in technology, as it's difficult to predict what might happen to such businesses in future.

Yet I'm still drawn to Sage. The company has over 30 years' experience working with small- and medium-sized companies, and its brand is globally recognised. I get the impression that customers would be reluctant to move away onto other systems, as it's cheaper for clients to stick with Sage, and they don't have to worry about training employees to use new systems.

Take a look at the company's contract renewal rate – 84%. This 'stickiness' should lead to fairly predictable revenues. On account of customer switching costs, I'd say that Sage has a decent 'economic moat'.

Looking at some key metrics, I reckon the company's performance is impressive. Some 75% of Sage's revenues were recurring in its last fiscal year, helped by the move to offering software subscriptions for its products, often known as the software-as-a-service model or SaaS. The increase in recurring revenues in 2015 was an enviable 9%. I think this is an attrac-

tive proposition for investors, since the recurring revenue model should keep the cash flowing in.

Sage claims that it has 72 million potential customers around the globe. It's reckoned that the majority of these currently use pen and paper or spreadsheets to manage their records. I believe this is a huge opportunity for Sage to grow over the long term, especially with its subscription-based product offering.

Previously, Sage offered a perpetual licence for a large up-front fee. Potential customers might view such expenditure as a risky capital decision. Now customers pay on a monthly or annual basis, Sage should be able to capture more of its addressable market. The early indications are that demand is strong, with the amount of subscribers to the Sage One cloud application doubling last year.

I see huge value in this strategy. The subscription relationships should have greater revenue potential since fees must be paid on an ongoing basis to use the product. There should be greater lifetime value in a subscription, rather than a one-off licence payment.

## Financials and valuation

I'm attracted by other economic aspects of Sage's business, too. The company's earnings come from its proprietary software code, rather than retail outlets or heavy machinery. Therefore, the business shouldn't require significant capital expenditures. As a result, Sage tends to churn out plenty of free cash flow to fund dividend payments. Last year, the company generated £298m of free cash flow, on revenues of £1.4bn.

I think Sage's dividend history is a marvel to behold. The company has increased its dividend for 15 years running. The historic yield is only 1.8%, but I think it has plenty of scope to increase its dividend level in future.

I believe Sage should be able to maintain high levels of recurring revenues, and earn impressive sums over the duration of customers' software subscriptions. Sage's aim is to "earn customers for life".

Although the shares presently trade at around 26 times estimated earnings, I believe the new business model provides greater earnings power than the company has had in the past, which is a fact which might not have been fully appreciated by most investors.

| Year ended 30 Sep | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| Sales (£m) | 1,340 | 1,376 | 1,353 | 1,435 |
| Pre-tax profits (£m) | 334 | 164 | 279 | 276 |
| Adjusted eps (p) | 19.8 | 20.2 | 21.7 | 24.0 |
| Dividend per share (p) | 10.2 | 11.1 | 12.1 | 13.1 |

## Risks and when I'd sell

Economic conditions, particularly across Europe, are a risk. Almost 60% of the company's revenue is from Europe, and in years when small European businesses struggle, Sage's progress might stall. Its market opportunity appears huge, which I feel is an adequate counterbalance to this risk.

Competition is also a threat. Intuit also offers online accounting software, and is planning a major expansion. However, Sage's new subscription model should allow it to engage more regularly with customers. More frequent feedback from customers should enable Sage improve its product suite, and build on its impressive recurring revenue base. In my opinion, Sage is more likely to grow its market share than see it competed away.

I'd be looking to hold Sage for the long term. I believe its dividends should grow in line with earnings and cash flow, and this investment should compound nicely from here. However, I might consider selling if stewardship of the company's cash became wayward, and shareholder returns suffered.

**Sources**

- *Sage annual reports*
- *S&P Global Market Intelligence*

**Disclosure**

- *As of 21 October 2016, Mark held no position in the companies mentioned in this section.*

# Fevertree Drinks

## "Cheers to growth"

by Ian Pierce

### What it does

Fevertree Drinks sells upmarket mixers such as tonic water, ginger beer and cola.

### Why buy?

- Significant long-term growth potential.
- Easily scalable and high-margin business model.
- Founder-led management team holds a 22% stake in the company.

| Market | Ticker | HQ | Website |
|---|---|---|---|
| AIM, UK | LSE: FEVR | London | www.fever-tree.com |

| Market cap | Net cash | Recent price |
|---|---|---|
| £1,120m | £19m | 971.5p |

*Price data taken on 21 Oct 2016, net cash as at 30 Jun 2016*

## About the company

Perhaps it's due to the popularity of celebrity Instagram accounts, or the ubiquity of reality TV programmes featuring the lives of the world's ultra-rich, but consumers have been developing quite a taste for the high life over the past decade.

Whether it's luxury clothing going mainstream, or the re-emergence of private member clubs, the trend towards 'premiumisation' has affected nearly every retail channel. Arguably no sector has embraced this change more than the alcohol industry, where we've seen astronomic growth in the craft beer segment and a concurrent rise in pricey spirits and cocktails.

This is the niche that premium mixer producer **Fevertree Drinks** (LSE: FEVR) has exploited with aplomb since its birth in 2005. The company's range of tonic waters, ginger beers and the like have won numerous awards and its classic tonic is consistently named the top selling and top trending brand by Drinks International's Top 100 Bars in the World.

Consumers seeing and tasting Fevertree in 'on-trade' locations such as trendy bars and restaurants are an increasingly driving sales through supermarkets.

## Investment Thesis

Why am I interested in Fevertree as an investment? Simply put, growth.

Between 2011 to 2015, sales have grown at an astronomical rate of 49% a year on average. Of course, as forward-looking investors we have to ask ourselves whether this rate of growth is sustainable.

I believe the opportunity is definitely there for Fevertree, due to the size of the small but rapidly growing high-end mixer market. A 2014 Ernst & Young (EY) report quoted by Fevertree in its AIM prospectus predicts the annual global premium mixer market could grow from £150m to between £720m and £1,600m by 2018. Obviously Fevertree won't be able to grab this entire amount, but as the dominant player it should be in pole position to win the race.

In tandem with attractive industry trends, the operational side of Fevertree's business is enticing, due to a largely outsourced production and distribution model. This model lends itself well to rapid growth, thanks to low capital requirements and easy scalability.

Ridding itself of the costly work of bottling and shipping its drinks, combined with a premium pricing point, led to operating margins reaching 29.1% in 2015.

With profit margins such as these and high growth prospects, competitors are unsurprisingly starting

to pop up. However, Fevertree has a significant first mover advantage through its international presence and its distribution agreements with all major supermarket chains in the UK.

As happened with craft beer, major industry players such as Schweppes have not found it easy to create premium mixer products that challenge newer brands like Fevertree at awards shows, or that resonate with hip bars and consumers.

Fevertree also has that old Motley Fool favourite characteristic, a founder-led management team. Besides retaining the CEO and Deputy Chairman positions, the two founders also retain a hefty 22% stake in the business.

## Financials and valuation

There is no escaping the fact that Fevertree is very highly valued by the market. Its shares change hands at roughly 60 times trailing twelve-month earnings. The question investors need to ask is whether investors are over-hyping Fevertree, or whether its potential is large enough to make this a reasonable valuation.

I believe the market opportunity is there. As before, the closest comparison I would draw upon is the runaway success of craft beer, which now accounts for 12% of the US market, and is growing increasingly popular abroad. The same phenomenon is occurring in the spirits industry, where overall sales are stagnating, but the premium category is seeing strong growth and feeding the premium mixer segment.

When I look at valuations in the craft beer industry, Fevertree starts to look a little more reasonably priced. There are only a small number of companies trading publicly, but one of a few comparable companies is Craft Brew Alliance, which trades at 300 times historic earnings!

Another example is Ballast Point, which was purchased in 2015 for $1bn when it had annual sales of $115m. Fevertree has a similar profile, with sales in the first six months of 2016 amounting to £40m and a market value of £1.1bn.

Figuring out a reasonable future growth rate is difficult given the relative immaturity of the premium mixer category. But, if Fevertree accounted for just one third of EY's lower-end 2018 potential market size then its sales would be four times their current level. Given that even the relatively mature UK market still grew year-on-year sales by 108% in the first half of 2016, I think this could even turn out to be a conservative projection.

| Year Ended 31 Dec | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| Sales (£m) | 16.3 | 23.3 | 34.7 | 59.2 |
| Pre-tax profits (£m) | 3.6 | (1.0) | 2.5 | 16.8 |
| Basic EPS (p) | n/a | (3.1) | 1.5 | 11.6 |
| Dividend (p) | - | - | 0.3 | 3.1 |

*Note: As the company listed quite recently, there is no comparable EPS figure available for 2012.*

## Risks and when I'd sell

The most glaring risk is the low barrier to entry in the mixer market. Maintaining its market leading position could require Fevertree to expand quickly and starve competitors of shelve space. This, of course, relies upon finding dependable distributors in over 50 countries.

Fevertree is reliant upon a steady supply of the all-natural ingredients it has built its brand around. While it keeps a six-month stock of quinine on hand in the UK at all times, it is vulnerable to supply shocks due to sourcing from relatively volatile countries, such as the Democratic Republic of the Congo, Ivory Coast and Nigeria.

The biggest red flag for me would be either of the deeply involved founders selling their stakes in the business, or stepping down from the management team. The two of them have built Fevertree up from nothing, so finding replacements that have their broad industry experience and in-depth brand knowledge would be difficult.

Considering Fevertree's current valuation, if growth were to slow considerably due to external factors such as a major rival stealing market share, the shares could be vulnerable.

A more positive possibility is acquisition by a larger competitor. Soft drinks companies, just like major brewers and spirits makers, have not been shy about acquiring their way into growth markets, and Fevertree could be a prime target.

### Disclosure

- *As of 21 October 2016, Ian held no position in the companies mentioned in this section.*

### Sources

- *Fevertree Annual Reports and AIM Admission Document*

# Gear4music

## "A rapidly-growing small-cap striking a Foolish chord"

by Mark Rogers

### What it does

Gear4music is a leading online retailer of musical instruments and equipment, operating 19 websites across Europe.

### Why buy?

- Spectacular organic growth in recent years.
- Founder CEO owns a 39% stake.
- Potential high-risk/high-reward opportunity.

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main, UK | LSE: G4M | York | www.gear4music.com |

| Market cap | Net cash | Recent price |
|---|---|---|
| £81m | £1m | 402.5p |

*Price data taken on 21 Oct 2016, net cash as at 31 Aug 2016*

### About the company

When it comes to finding shares in our small-cap stock picking service *Motley Fool Hidden Winners*, there are three broad sorts of opportunities we like to look for: Hidden Value, Hidden Growth, and Hidden Quality.

Rapidly growing online retailer of music instruments **Gear4music** (LSE: G4M) appeals strongly to the latter two of these styles of investing: Growth and Quality.

Gear4music recently reported organic growth of 73% year-over-year in its interim results, with profits surging into the black. Growth — tick.

The company is run today by its founder, Andrew Wass, who started the company while working as a sound recording engineer in 1995. He launched the "Gear4music" online retailing business in 2003.

At the Fool, we're big fans of well-run companies managed by visionary leaders with a passion for their industry. With a 39% stake in the company, Mr Wass has plenty of "skin in the game" alongside ordinary shareholders, a sign we love to see. Quality — tick.

As for "Value"… Gear4music trades at 54 times last year's earnings. On the face of it, that's admittedly rather pricey. However, as I'll try to convey, the company could well prove to be more than worth the lofty price tag.

### Investment thesis

Gear4music is a UK-based online retailer of musical instruments and equipment, focused on the lower end of the market, offering better prices than most traditional music shops. The company operates an office, showroom and distribution centre in York, and offers both own-brand instruments, as well as those from renowned brands such as Fender and Yamaha.

The company has enjoyed tremendous success since 2003, and it's not hard to see why. Its massive product range (boasting 32,000 items from 650 brands) and low prices make Gear4music more attractive to customers than high-street competitors. But it also retains enough of a niche (and low enough prices) to be competitive with the likes of Amazon. I believe the company still has a long way to go before it captures significant market share, leaving plenty of room for growth.

While the UK is Gear4music's biggest market, the company already generates 27% of its revenues from the rest of Europe, with 19 different websites in 15 different languages. This gives the company a significant runway for further international expansion.

While management estimates the UK market size is £750m, they think the overall European market is closer to £4.3bn — of which Gear4music currently represents less than 1%. A substantial opportunity.

Being an online operator focused on a niche market has other informational advantages. The company benefits from the specialist knowledge of its management team and staff, but also has the ability to gather large amounts of data on consumer behaviour and trends from its online platform.

As a leading player in the market, it also benefits from the trust of consumers, and can target its marketing more effectively for its audience. All these factors combine to give Gear4music incremental advantages over its rivals.

As mentioned earlier, organic growth (that is to say, growth that hasn't been enhanced through acquisitions) has been spectacular recently. Since 2013, sales have risen from £12m to more than £35m, and are expected to be considerably higher again in 2017.

This kind of growth makes the company challenging to value, but as I'll discuss in the next section, it's often worth paying up for…

## Financials and valuation

Gear4music is valued by the market at around £80m, compared to the £1.5m post-tax profit the firm is expected to earn this year. As I mentioned above, the shares seem to be already pricing in a fair bit of growth.

However, we're less interested in what the company is likely to earn this year, and more focused on the longer-term drivers and potential for the group. Growth has been rapid recently — it's this growth that could potentially propel profits at Gear4music and determine the future value of the business.

If the company can continue to reap the benefits of increased advertising expenditure, I believe the company's profits can exceed £5m in the next 3-5 years. While this requires some faith that Gear4music can fulfil its potential — which is of course not guaranteed — I believe the company could be worth as much as £150m in this timeframe, if it continues to take market share.

| Year ended 28 Feb | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|
| Sales (£m) | 12 | 18 | 24 | 35 |
| Pre-tax profits (£m) | -0.2 | -0.2 | -0.6 | 0.6 |
| Adjusted eps (p) | -0.8 | -0.6 | -2.6 | 3.0 |
| Dividend per share (p) | - | - | - | - |

## Risks and when I'd sell

It's important to note that when it comes to small-cap growth opportunities, the risks of failure can be high. This idea is certainly at the more speculative end of the investing spectrum, although it's a case where I believe the potential rewards — and the hallmarks of quality on offer — make it an interesting opportunity today.

Nevertheless, if Gear4music fails to live up to the market's expectations (which already prices in healthy growth from here) the shares could decline sharply. Much depends on the company's ability to continue to deliver top-line growth, and eventually, to deliver meaningful profitability.

If the company stalled in its efforts to take market share, and to continue its growth record, I'd possibly consider selling if I owned the shares.

### Sources

- *Gear4music annual reports and presentations at http://www.gear4music.com/*

### Disclosure

- *As of 21 October 2016, Mark held no position in the companies mentioned in this section.*

# The Restaurant Group

## "A tempting turnaround with a 4% yield"

by Zach Coffell

### What it does

The Restaurant Group owns and operates a number of restaurant chains across the UK. They also operate concession leases in a number of airports and train stations.

### Why buy?

- Shares trading at a low point compared to recent years, due to a fall in profits.
- An operational review has produced a clear plan of action to rejuvenate mismanaged brands.
- A 4% yield covered by free cash flow.

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main, UK | LSE: RTN | London | www.trgplc.com |

| Market cap | Net debt | Recent price |
|---|---|---|
| £790m | £36m | 391.2p |

*Price data taken on 21 Oct 2016, net debt as at 03 Jul 2016*

### About the company

If you live in the UK, you've likely been served a meal, snack or a coffee by The Restaurant Group (LSE: RTN). The company operates a myriad of brands across the length and breadth of the country, including Chiquito, Frankie & Benny's, and Garfunkel's.

The company's second business, TRG Concessions, leases and operates sixty outlets across thirty brands (such as Costa Coffee) in travel hotspots like airports and train stations across the country.

Combined, these restaurants and concessions businesses serve 43 million meals each year.

The company's brands are targeted at people in transit, with an emphasis on families that are out and about and need a quick bite to eat. Therefore, food offerings tend to be priced towards the value end of the spectrum, similar to other drop-in casual dining experiences.

And boy did that formula hit a chord with a ravenous UK public. We've gobbled up The Restaurant Group's offerings in the last decade, with revenue growing from £314m in 2005, to £685m in 2015.

That represents an impressive annual compounded growth rate of 8.1%. For a long time, the company commanded a premium rating because of its impressive and steady growth, but some recent mismanagement and a fall in like-for-like sales has dented investor confidence. The shares are down 45% over the past year, and I think this once-admired growth company looks cheap.

### Investment thesis

If you are considering making an investment in The Restaurant Group, it's important to remember that, while valuable, its brands are not best in class. Rather they are solid options for a quick bite to eat in a competitive environment.

The food is decent but not outstanding, while the price is neither offensive nor noticeably cheap. I've long felt Frankie & Benny's, Garfunkel's and some of the company's other chains don't have a clearly defined niche, aside from being conveniently placed for families on the move. In response to the fall in like-for-like sales, the company performed an operational review to figure out what's went wrong.

Essentially, the review concluded that the restaurant chains, especially the largest, Frankie & Benny's, have been poorly managed. The opening comments cut right to the chase: "Frankie & Benny's performance has suffered due to insufficient focus on value, unsuccessful menu development and poor operational execution."

When you read the list of mistakes, it's no wonder that sales have taken a hit. Above-market price hikes back-to-back in 2013 and 2014 isolated value-conscious customers, and in 2015 the restaurant chain did away with group offers too, thus completing the double-whammy for those pinching the pennies.

What's more, a new menu introduced last year removed a number of popular dishes. It seems likely this change was implemented without adequate research.

While these problems were worst at Frankie & Benny's, there were signs that similar issues affected the rest of the group, albeit in a less pronounced way. So the company is undertaking a thorough review of all its propositions, pricing structure and menu architecture.

This might sound worrying, but importantly I believe all of these issues to be fixable.

The capture of new CEO Andy McCue from Paddy Power looks promising, too. He took the reins at the betting company back in 2014, and oversaw an era of record revenues and profits, as well as the impressive merger with Betfair.

## Financials and valuation

In the past, the group has often traded at a heady rate of 25 times historical earnings, but the recent decline in share price means you can buy the shares for around 11 times.

The company is still generating free cash flow, bringing in £39m in the first half of 2016 alone. This is enough to cover its dividend. So, barring any further crisis emerging, I believe the dividend to be sustainable at its current level.

The management team has also acted swiftly, with 33 sites marked for closure or sale. This could increase 2017 operating profit by £6-8m.

If The Restaurant Group can steady its ship and return its level of business to a similar level as last year, I believe the share price would deserve a re-rating to around 15 times earnings. This could translate into a 34% increase from the current share price, and does not factor in any future growth.

When combined with the 4% dividend yield on offer at the current price, I believe the company could provide strong returns for shareholders going forward.

If the recent sales decline is stopped by the decisive action taken by management, I believe that the company has a strong enough balance sheet to speed up its expansion plans.

The company expects to open 24-28 sites by the end of the year, compared to 44 in 2015. This slowdown should allow management to spend more time on existing operational issues, rather than rolling out faulty formats.

| Year Ended 31 Dec | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| Sales (£m) | 533 | 580 | 635 | 685 |
| Pre-tax profits (£m) | 65 | 73 | 85 | 87 |
| Adjusted eps (p) | 24 | 28 | 33 | 35 |
| Dividend per share (p) | 12 | 14 | 15 | 17 |

## Risks and when I'd sell

The biggest risk facing the group is, in my opinion, the turnaround plan failing. The company faces other problems too (more on those in a minute) but if the atrophy of key brands continues, then any future rollout could do more damage than good. Therefore, it's incredibly important to keep a close eye on management communications for any signs of further missteps.

There are a number of challenges facing The Restaurant Group, including the Minimum Wage and reduced footfall in shopping centres, high streets and other locations where it operates, but I believe the company is robust enough to handle any cost inflation if the core formats can be fixed.

When to sell is a tough question to answer, largely because it's hard to know what the company might look like after a successful turnaround.

For example, if the share price were to rise in response to an improvement in the fundamental operations of the business, then one could choose to either take profits, or to stick around for the company's next stage of expansion.

Perhaps most importantly, if there are no signs of improvement in the key like-for-like sales figure in the next few years, I'd strongly consider selling because this could be evidence that the turnaround plan is failing.

### Sources and disclosure

- *Restaurant Group Annual Reports*
- *As of 21 October 2016, Zach held no position in the companies mentioned in this section.*

# Accesso Technology

## "Ticket to ride"

by Mark Stones

### What it does

Accesso Technology makes devices that help visitors avoid long queues at theme parks.

### Why buy?

- Unique small-cap company with a global niche.
- Signed big contract with Merlin Entertainments that should propel earnings.
- Talented management that have driven impressive growth.

| Market | Ticker | HQ | Website |
|---|---|---|---|
| AIM, UK | LSE: ACSO | Berkshire | www.accesso.com |

| Market cap | Net debt | Recent price |
|---|---|---|
| £360m | £10m | 1,625p |

*Price data taken on 21 Oct 2016, net debt as at 30 Jun 2016*

### About the company

We've all been there. You've driven to the theme park for a nice day out. The sun is shining. Your family is excited. And you've forked over a fortune for admission tickets. Then, once you walk through the entrance gate, something catches your eye. It's long, winding and stretches further than the eye can see.

You sigh. It's a massive queue. What a deflating feeling! **Accesso Technology**'s (LSE: ACSO) products offer a solution to this familiar problem, helping visitors avoid long queues.

Its Qbot product has been used by Six Flags, the American theme park operator, for more than ten years. The Qbot is a hand-held messaging device, that lets customers reserve a place on a ride. While visitors wait for their turn, they can walk around the park and enjoy the sights.

It's great for visitors, who are happier since they avoid standing in long lines. And great for Accesso's clients, who see increased revenues as visitors have more time to spend money elsewhere in the park.

During the last decade, Accesso's shares have soared. It has been one of the UK market's most notable 'multi-baggers', increasing by an astonishing 8,700%.

The company's first-mover advantage has allowed it to dominate its niche globally. In 2015 the company announced a big contract with Merlin Entertainments, the world's second largest theme park operator.

Accesso already boasted a strong reputation, and the Merlin deal should enable it to extend its market-leading position further.

### Investment thesis

Accesso is rolling out ticketing systems to Merlin Entertainments' attractions around the world, including LEGOLAND, Sea Life and Madame Tussauds. As of last year, Accesso's Passport ticketing system had been installed at nearly 30 venues, mostly in the US and in London. The entire estate, across Europe, Australia, New Zealand and Asia should eventually be served by the platform.

I'm impressed by this rapid expansion into new geographies, and the global scale the company could harness. Accesso has opened a new office in Sydney, to serve around 20 customers in the region, including the Merlin operations. As the business gains more scale, I think we will see it merging the operations of its ticketing and queuing product lines, servicing them through single sales teams. There is an apparent cross-selling opportunity, which I feel should drive organic growth.

In 2015, the company achieved adjusted operating profits of $12.6m, after cross-selling between its business lines and growing revenues. If the company can continue accelerating its organic growth rate, I think the shares should benefit from a nice tail wind.

Consider how many thousands of tourist attractions there are around the world – not just theme parks, but museums, cultural sites, sports stadia, and ski resorts…

If the Merlin deal can help Accesso become an even stronger brand, then we might see other clients follow suit and sign up with Accesso. I feel there's a huge market opportunity for the company. This is already somewhat reflected in the company's valuation I believe.

Nevertheless, I think Accesso could still be worth including in investors' portfolios as a more speculative growth idea. It's a unique small-cap business, in my view, with a dominant market position, global scale, combined with attractive organic growth potential. Think carefully about position sizing, however. And remember that small-cap shares can be volatile.

## Financials and valuation

On a trailing earnings basis, you could argue that Accesso shares appear ludicrously valued. The trailing price-to-earnings ratio is over 100! The valuation looks more reasonable if we look two years out, when earnings should be significantly higher due to the Merlin contract.

For 2017, brokers think the company should be capable of earning £17m, or over three times what the company earned last year. That looks more sensible to me, for a company valued at £360m. I think it's probable that Accesso could be a significantly larger business five to ten years from now and, as such, I believe it's worth paying up for growth.

Accesso reports in US dollars, but the table below shows its key figures in pounds sterling.

| Year Ended 31 Dec | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| Sales (£m) | 29.1 | 31.8 | 48.2 | 63.2 |
| Pre-tax profits (£m) | 3.1 | 1.8 | 3.9 | 5.2 |
| Adjusted eps (p) | 13.9 | 10.4 | 13.1 | 15.9 |
| Dividend per share (p) | - | - | - | - |

## Risks and when I'd sell

Changes to the management team would give me cause to revisit this investment. Tom Burnet, Executive Chairman, and Steve Brown, the Chief Executive are the key people in my opinion. Brown joined the company – then called Lo-Q – in 2012, and Burnet joined in 2010. I view losing management talent as a risk, since they have delivered highly credible performance in recent years.

A significant proportion of sales is denominated in US dollars – and although the majority of expenditure is also in dollars, the company is exposed to movements between currencies including sterling, the Brazilian real, and the Mexican peso.

I'd be compelled to sell in the event of a management shift, if a credible strategy wasn't presented to continue growth.

If Accesso is securing new contracts, and cross-selling more of its products, I'd be looking to hold the shares for five years or more. Bear in mind that small-cap shares tend to be more volatile, and there may be violent swings in price either up or down. However, if the company appeared to be finding it exceptionally difficult to acquire new contracts, the growth I expect might be threatened. If growth appeared particularly uncertain, it might be reasonable to consider selling.

### Sources

- *Annual reports*
- *S&P Global Market Intelligence*
- *Company website*

### Disclosure

- *As of 21 October 2016, Mark owned shares in Accesso Technology.*

# The Boston Beer Company

## "A worthwhile tipple for your portfolio"

by Nathan Parmelee

### What it does

The Boston Beer Company is a US-listed company that sells 60 varieties of beer under the Samuel Adams brand, hard cider under the Angry Orchard brand, and other malt beverages under the Twisted Tea brand name.

### Why buy?

- Craft beer appears out of favour in the US right now, potentially creating a good buying opportunity.
- Long-term growth prospects for the craft beer segment still seem strong, and Boston Beer is the segment leader.
- A debt-free balance sheet and consistent cash flow should give Boston Beer the option of selectively acquiring competitors.

| Market | Ticker | HQ | Website |
|---|---|---|---|
| Main, USA | NYSE: SAM | Boston, MA | www.bostonbeer.com |

| Market cap | Net cash | Recent price |
|---|---|---|
| $2.0bn | $77m | $163 |

*Price data taken on 21 Oct 2016, net cash as at 24 Sep 2016*

### The Company

**The Boston Beer Company** (NYSE: SAM) was started in 1984 when Founder and Chairman Jim Koch sensed that the US beer market was ready for more choice and flavour than what was offered by Anheuser Busch-Inbev and the other giants that dominate the market.

Koch, who had already finished school and begun a career as a management consultant, took his grandfather's lager recipe and brewed the first batches in his kitchen. He took the finished product, packed it in his briefcase, and began going bar-to-bar in the Boston area to sell the beer he called Samuel Adams Boston Lager.

The beer — named after the revolutionary Adams, because Koch wanted to start a revolution in the beer industry — was an instant hit and went on to win multiple beer of the year awards in the US and Europe.

Boston Lager put Koch and The Boston Beer Company at the centre of the US craft brew revolution and the company remains there today. The Boston Beer Company now brews 60 varieties of Samuel Adams beer and also makes Angry Orchard, the leading hard cider in the US.

### Investment thesis

There's been talk of a bubble in the US craft brew scene and with good reason. In 2015 it's estimated that 10 new craft breweries per week were opening in the US. That's brought the total number of craft brewers to 4,200 compared to just 2,400 in 2012 and 1,485 in 2003.

Boston Beer has been here before. In 1996 the last craft beer bubble burst and sales were flat for five years. During those dark days Boston Beer reduced costs, grew its profitability each year, and emerged stronger. In 2002 the company returned to growth and sales grew right through the financial crisis until this year.

Now the industry is struggling to grow again. Boston Beer is already retrenching and once again talking about improving margins and efficiency, and investing in its Samuel Adams brand for the long term.

I believe Boston Beer should emerge stronger, because it has the financial strength to endure and

its management has been through this before. I also believe growth should return to the industry again, because despite its torrid growth the craft beer category still represents just 12% of all US beer sales.

As one of the largest craft brewers, Boston Beer should be able to weather the storm. Its size gives it the scale and distribution that other craft brewers can't match. But the company still has room to grow, too, because it represents just 1.5% of the total US beer market compared to 45% for Anheuser-Busch and 26% for MillerCoors.

I believe that an investment in Boston Beer should work out well, even if the industry takes a little while to regain its footing. With a debt-free balance sheet and consistent cash flow, Boston Beer can selectively acquire other craft brewers with great products that run into financial difficulty.

It's also possible that Koch could lead a leveraged buyout of the company, which would allow him to operate the company freely out of the public eye. Koch already owns 27% of the shares, and has even greater voting rights through the Class B shares he holds.

## Financials and valuation

Boston Beer currently sells for about 11 times enterprise value-to-EBITDA (earnings before interest, taxes, depreciation, and amortisation). Going back to 2002 the annual average for Boston Beer has ranged from 9.4 times to 19.7 times, so we're near the low end of its historical range. It also sells for 15 times operating cash flow.

The shares could always get cheaper in a prolonged downturn, but given Boston Beer's history of using these periods to retrench and improve margins, I think it makes sense to start gradually building a position now.

Boston Beer's margins are impressive, though still below the 20% to 30% Anheuser Busch, MillerCoors, and other industry giants earn. Over the last twelve months Boston Beer recorded an operating cash flow margin of 14.9%.

In comparison, Craft Brew Alliance, which is the second largest publicly traded craft brewer, notched an operating cash flow margin of just 4.0%. That's Boston Beer's scale at work, and why I think it is so well positioned to ride out any industry downturn.

| Year ended 31 Dec | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| Sales ($m) | 580 | 739 | 903 | 960 |
| Pre-tax profits ($m) | 96 | 114 | 147 | 155 |
| Adjusted eps ($) | 4.4 | 5.2 | 6.7 | 7.3 |
| Dividend per share ($) | - | - | - | - |

## Risks and when I'd sell

For the next two years I'm assuming sales growth may be a challenge. Boston Beer could counter this with new product launches, expanded distribution, and a renewed focus on efficiency to improve profitability. But in a downturn I think it makes sense to expect negative headlines and pessimism until it is clear these efforts are working.

Price wars are another consideration. Currently Boston Beer's scale and distribution allows it to price Samuel Adams below the competition and still earn a healthy profit. However, struggling brewers that are desperate for cash may attempt to sacrifice short-term profitability in order to survive, which could put pressure on Boston Beer.

Anheuser-Busch, Heineken, and other giants have been actively acquiring craft brewers over the last few years to offset their declining sales. They could drive up the cost of acquiring struggling brewers, though I suspect most would prefer to be acquired by a fellow craft brewer such as Boston Beer.

If the craft beer industry returned to broad growth and there were clear signs that Boston Beer continued to struggle, then I would be inclined to sell.

Koch owns a 27% economic interest in the company, but through his 100% ownership of the Class B shares elects 5 of the 8 directors to the board and has effective control of the company. This hasn't led to conflicts historically and the company has a good track record of allocating capital. However, if there were signs of self-dealing or favouring insiders over shareholders I would look to sell.

**Sources**

- *Boston Beer Annual Reports and website*

**Disclosure**

- *As of 21 October 2016, Nathan held no position in the companies mentioned in this section.*

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