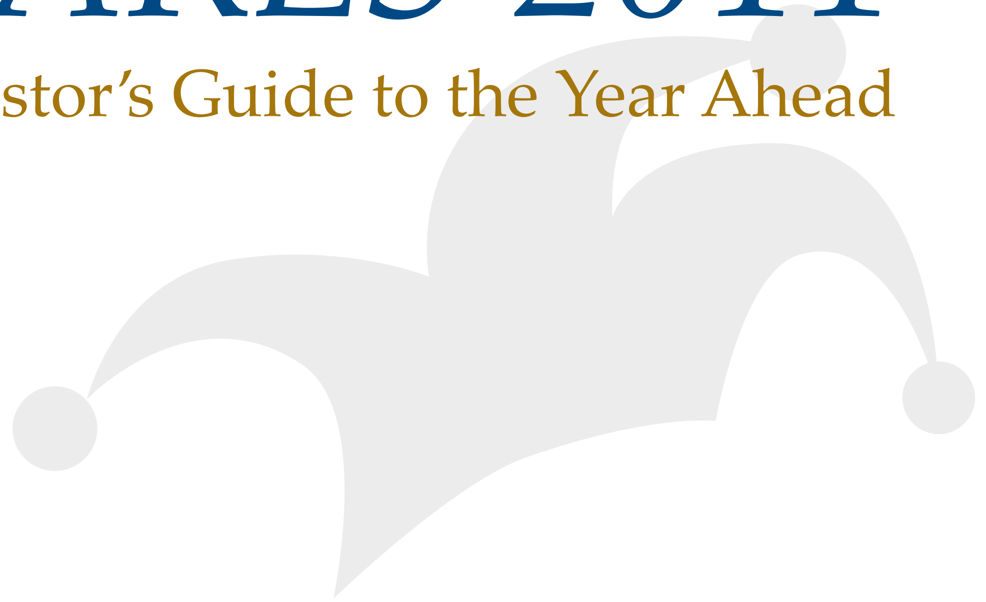
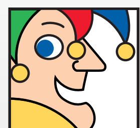
SHARES 2011

The Investor's Guide to the Year Ahead



From The Motley Fool's Top Analysts



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Introduction

BY STUART WATSON

Welcome to The Motley Fool's Shares 2011 report. Our Foolish writers have picked eight shares that they think have the potential to beat the market in 2011 and beyond.

Before we take a look at those, you might be wondering how our picks did last year. Good question! Here's how they fared...

Company	Price as at 5 Nov 2009	Price as at 12 Nov 2010	Gain/(loss)
Charlemagne Capital	17.75p	19.25p	+8.5%
Goodwin	1,038p	1,239.4p	+19.4%
GlaxoSmithKline	1,220p	1,220.5p	+0.0%
Hansard	175p	170p	-2.9%
Healthcare Locums	266p	110.25p	-58.6%
National Grid	543.8p	586p	+7.8%
Nautical Petroleum	60.5p	375.75p	+521.1%
PV Crystalox Solar	66.15p	52.75p	-20.3%
Telecom Plus	297.5p	379.75	+27.6%
Tesco	418.7p	417.45p	-0.3%
FTSE 100	*5,125*	*5,797*	*+13.1%*
Average of all 10 picks			**+50.2%**

Notes: Gains are measured on a mid to mid price basis and do not include dividends. The FTSE 100 return does not include dividends either. The National Grid start price has been adjusted for the rights issue announced on 20 May 2010 and we assumed that the rights were taken up in full.

Taken as a whole, we were very pleased with the overall performance. Our average gain was 50%, compared with the 13% produced by the FTSE 100. 5 shares produced gains, 2 were unchanged and 3 were losers.

However, you don't need to look at the table that closely to see that our outperformance was primarily due to just one share – Nautical Petroleum. The oil explorer came up trumps not once, but twice, when it announced discoveries at its Catcher and Kraken prospects in the North Sea.

The biggest loser was Healthcare Locums, which saw its share price bashed after it confessed to some aggressive accounting over the timing of its revenues. A mooted bid provided some temporary respite, but that came to nothing and the shares have drifted lower again.

So what's the lesson here? As an investor, we think it's crucial to have a diversified portfolio. The shares we picked last year came from a variety of sectors and ranged in size from tiddlers to some of the largest companies on the UK market.

You can't avoid losses of course, but choosing a broad mix of companies helps you minimise the downside. Storms do come along in investing, and they tend to be more frequent and more damaging than most investors seem to expect.

WHAT'S IN STORE FOR THIS YEAR?

There's been plenty of gloomy stories around in the last twelve months. Despite that, the stock market has managed to move steadily ahead.

Based on earnings estimates for 2011, we still think there is decent value out there. Bloomberg estimates put the UK market on a price earnings ratio of 12 times for 2011, falling to 10 times for 2012. As always, the question is... can you trust the profit forecasts? Analysts are expecting a sizable jump in corporate profits and there's obviously a risk that such increases won't be achieved.

So that's the background against which we have picked the seven shares in our line-up for Shares 2011. Once again we have a mixture of blue chips (Smith & Nephew, GKN), mid-sized firms (Halfords, Mothercare) and small caps (NCC, McKay Securities, Velosi).

Overall, we reckon that this is a slightly riskier group of shares than last year. We've leant more toward small caps and we have two retailers in the mix.

As before, each company get its own detailed review where we look at the business, the numbers, the risks and what factors might cause us to consider selling out.

We hope you enjoy this report and that we'll see you again for Shares 2012.

Fool on!

Stuart Watson
Investing Editor - *Fool.co.uk*

Velosi: Unrecognised Value in Oil Services

BY DAVID HOLDING

VELSOI

LSE: VELO
Market: AIM
Headquarters: Reading
www.velosi.com

FINANCIAL SNAPSHOT

Recent Price:........................102.5p
Buy Guidance: **125p**
Market Cap:..........................£50m
Net cash (30/06/10)..................£11m
(Price data as of 12/11/10)

WHAT IT DOES

Velosi provides testing, inspection, and certification services to major national and multinational oil and gas companies.

WHY BUY

» Strong balance sheet
» Low rating
» Unrecognised growth potential
» Sector buoyancy

STOP PRESS!

On 9 December 2010, **Velosi** received a takeover offer at **165p** per share. However, for completeness, and in case the bid does not proceed, we have kept this review in our report.

ABOUT THE COMPANY

Velosi (LSE:VELO) provides asset integrity, health, safety and environment, quality assurance, quality control and engineering services to a number of leading national and multinational oil and gas companies, including BP, Shell, ExxonMobil, and Chevron.

The company inspects drilling and other equipment to see that it works properly, researches sub-contractors, and generally covers the gamut of services as a "one-stop-shop", from quality assurance through to legislative certification.

Overall, its services aim to remove the problems faced by the world's biggest oil companies as they try to control operations remotely, in unfamiliar territories – providing local knowledge and experience through its worldwide network.

Velosi operates globally through five regional headquarters in the US, the UK, Malaysia, South Africa, and the UAE. It has 63 offices in 36 countries worldwide. The company floated on AIM in 2006 at 90p.

INVESTMENT THESIS

Take a low price-to-earnings ratio (looking both forward and back), add a hefty dollop of cash and assets, and you have a company at least worthy of a little more digging. Such is the case with Velosi. This may sound simplistic stuff, and it is – but it is the basis for an investment.

Meanwhile, the macroeconomic backdrop looks favourable for oil services companies, but that hasn't yet been fully reflected in Velosi's share price.

BP's Deepwater Horizon drilling rig disaster in the Gulf of Mexico highlighted the need for the services of companies like Velosi all too starkly. As wells become increasingly complex, and the oil majors work in ever harsher deepwater environments, the market for services such as those provided by Velosi should continue to increase. This overall trend may take the odd blip now and again, but doesn't seem likely to change fundamentally for the foreseeable future.

Overall, I see the big picture being a favourable one and the prospect of increased earnings being very real for Velosi.

The company's main focus is to continue to exploit its one-stop-shop position for the majors in its chosen geographical markets. To this end, it has focused on maintaining a strong cash position to invest in developing the business to drive future revenue growth.

During the first half of 2010, Velosi opened new offices in Papua New Guinea, Malaysia, Thailand, Pakistan and Poland, and increased its number of staff to expand its services, in anticipation of a pick-up in business.

The investments in developing the business added to the company's costs and impacted the half-year results to the end of June 2010. This knee-jerk reaction knocked the share price, unfairly in my opinion, from over 120p to under 100p, but Velosi still managed a respectable first half pre-tax profit of $7.4m – down from $7.9m for the first half of 2009.

Like most oil-related companies, Velosi reports its figures in US dollars. This means unfavourable exchange rate movements could hurt returns for UK investors.

I expect we'll see the pick-up in business the company anticipated, when the final results are announced in April. But the main clues to the underlying long-term value will be in the outlook statement.

What I particularly like about Velosi, given the strength of its balance sheet and the continued reliance of the world's major and developing economies on oil, is the relative comfort with which investors can average down their share purchase price, should fortune move against the company.

This is a growing business, in an expanding sector, which is cash and asset-rich and is making what appear to be the right moves to fuel its future growth – yet these factors seem to be going largely unnoticed by the market.

FINANCIALS AND VALUATION

At 102.5p per share, Velosi's market capitalisation is £50m. At the end of June, the company had net cash of £11m, whilst brokers' consensus forecasts are for earnings per share of 13.5p for the full year to the end of December 2010, rising to 16.0p for 2011.These forecasts compare realistically with historical earnings.

Year ended 31 Dec	2006	2007	2008	2009
Sales (£m)	43.6	72.7	113.0	114.0
Pre-tax profits (£m)	5.0	7.1	9.3	10.4
Adjusted eps	12.4p	11.8p	13.5p	14.2p
Dividend per share	0.62p	0.62p	0.62p	0.93p

**Figures for all years have been converted at £1:$1.61.*

Stripping out the cash, this places the shares on a potential price-to-earnings ratio of less than 5. Then, when you consider that Velosi had net assets of £52m and net tangible assets of almost £42m at the last count, it's easy to see why the shares look good fundamental value.

Also, the company says it is adopting a more progressive dividend policy, as a result of the continued improvement in trading. Last year's dividend was 1.5 cents per share.

RISKS

Clearly, a buoyant oil price and the continued economic good fortunes of the oil majors are crucial to Velosi's success. When the price of oil was at its lowest, and the world was on the brink of economic disaster back in March 2009, Velosi's shares dropped to their lowest-ever level of 35.5p.

Meanwhile, Velosi's latest balance sheet showed almost £40m of trade receivables. Although most of the company's clients are major oil companies, this is a high figure in relation to its market capitalisation.

The company has also stated its intention to grow by acquisition. Misguided acquisitions can be the enemy of value – though, to date, I think Velosi has an admirable track record in preserving its cash.

WHEN I'D SELL

The company looks undervalued to the tune of around 50% to me, so I'd sell if and when the shares reached 155p in the relatively short term (a year or less). If, on the other hand, there is a gradual share price rise, along with a gradually improving performance, Velosi could make a solid long-term buy and hold investment; provided that the fundamentals continue to make good sense.

On the downside, the shares could fall on generalised macroeconomic bad news and a falling oil price (as happened during late 2008 and early 2009). However, I would probably use this as an opportunity to average down the cost of my purchase, given the solid nature of the company, the cash balance and the world's continued reliance on oil.

THE FOOLISH BOTTOM LINE

I believe Velosi is a well-managed and growing business, with a solid balance sheet performing an essential service for oil majors. Its continued low valuation appears unjustified to me.

Halfords: More than just a Bike Shop

BY ALAN OSCROFT

HALFORDS

LSE: HFD
Market: Main
Headquarters: Redditch
www.halfordscompany.com

FINANCIAL SNAPSHOT

Recent Price: 410p
Buy Guidance: 460p
Market Cap: £868m
Net Debt (01/10/10) £110m
(Price data as of 12/11/10)

WHAT IT DOES

Halfords runs a chain of high street cycle and motoring accessories stores, and owns the Nationwide Auto Centre MOT and servicing centres.

WHY BUY

- Track record of increasing sales, profits and dividends
- Top quality, prudent, management, with a long-term view
- Growth through well-targeted acquisition
- Strong prospective dividend yield and low P/E

What, the bike shop? Well, yes and no. Yes, Halfords runs the well-known chain of high street cycle and motoring accessories stores. But no, after acquiring Nationwide Autocentres, the country's largest independent MOT and care servicing operator early in 2010, Halfords is more than that.

While many companies, especially in the retail sector, had a hard time through the recession and struggled with debts, Halfords seems to have barely noticed. Profits dipped very slightly in 2009, but sales kept growing and the dividend kept on rising.

ABOUT THE COMPANY

Halfords has been in business since 1902, and for much of that time has been primarily associated with bicycles. It has expanded its range considerably in the last 108 years, but it does still sell a lot of bikes.

In its last financial year, Halfords sold more than a million bicycles. According to GFK NOP Consumer Research, those sales accounted for 30% of the total UK cycling market, with Halfords' Apollo brand being the country's number one.

As well as selling a huge range of replaceable car bits, like bulbs, batteries, spark plugs, and seat covers, Halfords is also one of the UK's biggest sellers of satellite navigation and car audio equipment.

In 2010 Halfords acquired Nationwide Autocentres. To be rebranded as Halfords Autocentres, the move expands Halfords from just selling accessories into car maintenance.

As of March 2010, Halfords was running 462 stores in the UK and Ireland, and now has 224 autocentres too.

INVESTMENT THESIS

The case for investment in Halfords is largely based on its financials, covered below. But for a long-term investment, we also need confidence in the company's management, and evidence that they are committed to growing the company in a sustainable way.

Halfords' management has easily demonstrated its prudent approach to steady growth over a good many years, and that became more apparent through the last couple of years of general financial turmoil.

Halfords is not a company that sways from periods of rapid expansion and acquisition in good times, to offloading assets and struggling with debts during darker days. Instead, it has gradually pushed its core strengths outwards, expanding into new areas of motoring accessories – like satellite navigation equipment in recent years, to become a leading player in the market.

That was amply demonstrated in the recent acquisition of Nationwide Autocentres. At a time when many companies were still hurting from the credit crunch and the general economic slowdown, Halfords was able to come up with £73m to seal an all-cash deal, while keeping its end of year net debt at its lowest figure in recent years.

For that £73m, Halfords gained control of 224 autocentres, with plans to open up to 200 more. The autocentres carry out MOT tests, fit tyres, and do general vehicle maintenance, which makes for a logical step up from the retailing of the company's wide range of spare parts and accessories.

At the time of acquisition, according to Halfords' statement of 18 February 2010, the company was expecting the rebranded Halfords Autocentres to double its operating profits, to £20m, by its third year, and to add 6% to earnings per share in the first full financial year.

That, to me, looks like an exceptionally well spent £73m.

FINANCIALS AND VALUATION

The Halfords financial picture for the last four years is as follows:

Year ended 31 Mar	2007	2008	2009	2010
Sales (£m)	744	797	810	832
Pre-tax profits (£m)	81	90	78	110
Adjusted eps	29.3p	29.3p	26.6p	36.6p
Dividend per share	13.9p	15.1p	15.9p	20.0p

What we see is steady growth in sales, earnings and dividends. Earnings per share fell slightly in 2009, the worst year of the recession, but bounced back strongly in 2010.

We also see dividends rising continually. And crucially, they have always been well covered by earnings – even the 2009 dividend was covered 1.67 times.

Over the past four years, Halfords has maintained its net debt at a steady level, falling slightly from £180m at the end of 2007, to £110m by October 2010 (even after shelling out for Nationwide Autocentres).

A company's operating margin is another indication of its underlying strength, and Halfords' has been steady. From 12.7% in 2008, it dipped to 11.3% in the recession year, and bounced back to 13.5% in 2010.

Interim figures for the six months to 1 October 2010 showed overall sales up 7.3% (though like-for-like sales were down 4.9%). Pre-tax profit was up 12.8% and earnings per share up 17%. An interim dividend of 8p was declared – a third higher than last year's.

Analysts' forecasts for the next two years are positive, with the current consensus suggesting earnings per share of 45p for 2011 and 49p for 2012. This gives us a prospective P/E for 2011 of 9, falling to 8.3 for 2012.

Analysts have dividends of 22.7p and 24.8p penciled in for the next two years, and if those are accurate, the current share price will get you a dividend yield of 5.5% in 2011, and 6.0% the next year. That's well above the market average.

RISKS

The main risk is probably poor investor confidence, with fears that it might be a few years yet before we get back to normal economic growth. And any figures that come even slightly short of expectations might cause the price to fall, as it did at the end of 2008 when the sheer panic surrounding the credit crunch forced the shares down to half their current price.

But if that should happen, I believe Halfords' positive dividend strategy should see it through.

We also don't yet know how smoothly Nationwide Autocentres will integrate into the group. Acquisitions can cause some companies to lose focus and generally muddy the figures. Also, any changes to MOT regulations could impact this part of the business.

WHEN I'D SELL

This is a share that I would be looking at with a long-term view of 10 years or more, providing the dividend holds up. If I saw any sign of the dividend faltering, I'd look to exit, as that would probably signal an underlying problem – a steady dividend is a core part of Halfords' strategy.

And if the current undervaluation were outed by a rising share price, and the prospective dividend yield were to fall to under 4%, I'd start to look for a better place for my money.

THE FOOLISH BOTTOM LINE

The bottom line here is that we have a good company with an impressive track record, very recent evidence of good strategic decision making, and whose shares are offering a prospective dividend yield of 5.5%. I reckon that has got to be a bargain.

Smith & Nephew: A Healthy Addition to your Portfolio

BY TODD WENNING

COMPANY NAME

LSE: SN.
Market: Main
Headquarters: London
www.smith-nephew.com

FINANCIAL SNAPSHOT

Recent Price:........................ 594p
Buy Guidance: **620p**
Market Cap:....................... £5.3bn
Net debt (30/10/10)............... £373m
(Price data as of 12/11/10)

WHAT IT DOES

Smith & Nephew is a global healthcare company specializing in orthopaedic reconstruction and trauma, endoscopy and advanced wound management.

WHY BUY

» Focused on younger, more active patients
» Recent big patent victory in the US could help it expand
» Steady cash flow
» Recent fall provides buying opportunity

ABOUT THE COMPANY

The human body is an incredibly beautiful machine, but like any machine it will eventually need repairs, particularly as it gets older. Fortunately, amazing strides in medical technology over the past century have helped the human body recover from once-catastrophic or life-ending injuries. And as the world's elderly population increases, more surgeries will be needed – according to a UN estimate, the number of people aged 65-plus around the world will have tripled to nearly 1.5 billion in 2050.

Though some surgeries have been delayed during the recession, it's unlikely that patients will permanently put them off. Eventually, bad knees, hips, and shoulders need to be fixed and there's one company that I particularly like in today's market to profit from this long-term trend.

Though it began as a humble family-owned chemist in Hull in 1856, Smith & Nephew, the medical equipment company really began to take shape in 1896 when Horatio Nelson Smith, the founder's nephew (hence the "Nephew" in the company name), began to develop medical dressings. It was a wise move, for today Smith & Nephew is one of the world's largest medical device companies with operations in over 32 countries.

S&N's business has also since expanded well beyond medical dressings, into three distinct segments:

Orthopaedics (57% of 2009 group turnover) – this division deals in hip, knee, and shoulder reconstruction, trauma products to mend broken bones, and biological treatments to promote healing and pain relief.

Endoscopy (21%) – endoscopy is just a fancy way for scientists to say "looking within", or in medical parlance, looking within the patient's body. S&N develops techniques and products like tiny cameras, scopes, and blades that surgeons use to treat and repair soft tissue and joints. Such minimally-invasive surgical techniques can lead to fewer complications, better outcomes, and shorter hospital stays and will likely therefore be in greater demand as hospitals and governments look to reduce health care costs.

Advanced Wound Management (22%) – treatment of pressure sores, venous leg ulcers, and chronic wounds is not a simple process. Wounds that can't be sutured, or otherwise can't heal by themselves, require proper fluid management and a catalyst (i.e. suction) to promote healing and stave off infection. S&N's negative pressure wound therapy (NPWT) products address this growing market (estimated at $5 billion), which is fuelled by ageing populations and greater incidences of diabetes and obesity.

Each of these businesses have a number of demographic and lifestyle tailwinds, and Smith & Nephew is among the top four in market share in each of its categories, including #1 in sports medicine endoscopy and #2 in advanced wound management.

I reckon that these three great divisions, combined with what looks like an undervalued share price, make S&N a great buying opportunity right now.

INVESTMENT THESIS

At this point, you might be asking "If each of these businesses is so promising, why isn't the share price higher? Wouldn't the market price the stock according to its growth potential?"

Concerns about increased government involvement in health care (read: lower pricing), especially in the US and European markets, has a lot of investors understandably spooked. In fact, if you consider the multiples on a number of health care stocks, the markets seem to have been worrying about this phenomenon for some time.

Consider the changes in P/E ratios of some medical device firms since 2003:

Company	Average P/E - 2003	Average P/E - 2006	Average P/E - 2010	EPS Growth 2003-2010
Smith & Nephew	35	26	17	17%
Stryker	39	28	18	17%
Zimmer	35	22	17	12%
Medtronic	37	26	16	13%

All data provided by Capital IQ as of Nov. 4, 2010. Growth rates are annualised

Even though each of these companies has growing earnings at double-digit rates during this time frame, the best performing share among them is Stryker, which is up just 20% since 2003.This is due to a rapid contraction of health-care multiples, a trend I believe has more to do with fears of government intervention than business outlook.

There is precedent for this explanation. In the early 1990s, as former US president Bill Clinton set out to reform health care in the States, US health care stock multiples contracted sharply. After Clinton's health care reform fell apart in 1993, US health care stocks gained an average 30% annually through 2000.

Certainly the world has changed a lot since the 1990s, and by no means am I forecasting 30% annualised returns in health care stocks over the next seven years, but this example does go to show how quickly overblown fears in this sector can reverse course. With Republicans having recently regained control of the US House and more power in the Senate, parts of President Obama's health care reform could be repealed and replaced, or at the very least, obstructed.

More specifically to Smith & Nephew, the company won a recent patent case over Kinetic Concepts, whose NPWT technology constituted a virtual monopoly in the very profitable advanced wound management field for over a decade. Now, S&N's foam-based dressings can compete head-to-head with Kinetic's in the US and this could be a good long-term growth area.

FINANCIALS AND VALUATION

Smith & Nephew is built on a firm financial foundation and it's paid a dividend each year since 1937. Even though revenue growth has been weak during the recession, profit margins have been improving thanks to a number of cost-cutting measures like moving some of its production to China and a greater focus on leaner operations all around.

Year ended 31 Dec	2006	2007	2008	2009
Sales ($bn)	2.8	3.4	3.8	3.8
Pre-tax profits ($m)	550	469	564	670
Adjusted eps	41.9c	52.0c	55.6c	65.6c
Dividend per share	10.81c	11.89c	13.08c	14.39c

The balance sheet is strong, with a robust interest cover ratio of 32 times. Though some £675 million of debt is coming due in 2012, given its solid financials, I don't think S&N should have much trouble refinancing that debt at attractive rates.

To put a value on S&N's shares, I used a two-stage discounted cash flow to firm model that assumed between 6-7% operating profit growth for the next five years, a discount rate (weighted average cost of capital) of 9%, and 2% terminal growth. From this model, I'm comfortable putting a fair value on S&N shares between 650-700p – which gives a decent margin of safety from the current price.

RISKS AND WHY I'D SELL

The major risks to keep in mind when considering Smith & Nephew are further government intervention in the pricing and regulatory approval process, potentially poor acquisition or investment decisions by S&N, and the weight of litigation costs.

Management also has a shaky past with acquisitions. In 2008, for example, S&N paid £450 million for Plus Orthopedics, a Swiss company, which it later found to have had "unacceptable" sales practices. Hopefully S&N management learned its lesson, but it's natural to wonder how rigorous their due diligence is when making larger acquisitions.

THE FOOLISH BOTTOM LINE

With health care stocks currently out of favour, investors should consider some of the higher quality names in the industry to buy and hold for a number of years. I reckon that Smith & Nephew, with its global reach, market leadership, and strong financial footing is one such company. Its dividend yield of 1.6% isn't anything to get excited about, but it can keep you warm as you wait for the stock to reach fair value.

Disclosure: *As of 12 November 2010, Todd owned shares of Kinetic Concepts.*

McKay Securities: Quality UK Real Estate at a Discount

BY DAVID HOLDING

MCKAY SECURTIES

LSE: MCKS
Market: Main
Headquarters: Reading
www.mckaysecurities.plc.com

FINANCIAL SNAPSHOT

Recent Price:........................ 128p
Buy Guidance:.................... 160p
Market Cap:.........................£59m
Net debt (30/09/10).................£90m
(Price data as of 12/11/10)

WHAT IT DOES

McKay Securities is a commercial property investment company with Real Estate Investment Trust (REIT) status, specialising in the development and refurbishment of quality buildings in the South East and London.

WHY BUY

» Healthy discount to net asset value
» Good potential for share price recovery
» Excellent potential yield
» Secure, diverse income
» Conservatively managed

ABOUT THE COMPANY

McKay Securities was formed in 1946, by its eponymous founder Peter McKay, and was floated on the London Stock Exchange in 1959. It's a property investment company that specialises in the development and refurbishment of quality commercial buildings, mainly in South East England, which are then usually held for growth.

Initially, McKay specialised in the residential sector by building and letting out houses and flats in Somerset, Essex and Kent, and thereafter in London. But after going public, the company began to focus increasingly on commercial projects. In early 2007, McKay received the shareholder approval it needed to become a Real Estate Investment Trust (REIT).

The company's commercial investment and development projects are concentrated in London and other established growth centres in the South East England, but major schemes have been completed elsewhere (such as a 100,000 sq ft office scheme in Glasgow city centre).

Today, the portfolio consists of 31 properties, totalling 1.2 million sq ft and valued at £206m. They are let to 129 tenants. Almost 80% of the portfolio is invested in the office sector, with the balance mainly in the industrial sector. Occupiers represent a diverse range of business sectors, the largest of which is financial and business services, accounting for 31% of annual contracted rents.

McKay's business model is one of: "Buy – manage – develop/refurbish – manage – sell/recycle". I believe it has an enviable track record of putting this into practice.

INVESTMENT THESIS

Commercial property has been something of a no-go area for investors over the past couple of years – though those timing their investments to near perfection may have made money.

There are many commercial property companies you could choose that stand at a healthy discount to net asset value (NAV) and McKay is one of them.

One reason such companies stand at hefty discounts to what should be the realisable valuation of their properties could be concerns over their debt levels. There's a very good reason for this – many commercial property loans made in recent years are now worth more than the properties they're secured on!

Most commercial property loans include a loan-to-value covenant that requires borrowers to top up their equity if valuations fall below agreed ratios. Investors are understandably nervous of the likelihood of discounted rights issues in order to do this – or worse, the prospect of "fire sales" or even administration.

Also, recessionary conditions affect tenants and their ability to pay, as well as overall occupancy rates. Add to all that the way that stock markets tend to follow fashion, and fears of a double-dipping nature, and it's easy to see why many property companies' valuations have fallen so low.

But these companies aren't all the same. Some stand out, as they have lower gearing, bigger discounts to NAV, better properties and tenants etc. So it's a matter of taking all variables into consideration before making your choice accordingly.

What I like about McKay is that it offers a little of everything; a big discount to NAV, reasonable gearing for the sector, and what appear to be good quality properties let to good quality tenants. Then there is a good yield which is well covered, a proven track record and a good capital return over time on investment from properties managed.

McKay has been selling properties for more than book value, thus reducing loan-to-value gearing. It is keeping the market under review, but has made no acquisitions.

As at 30 September 2010, its NAV per share was 163p, while its EPRA NAV was 231p. EPRA NAV is a standardised measure created by the European Public Real Estate Association that adjusts for various accounting factors, such as the current value of debt instruments and deferred taxation on revaluations.

I believe that McKay's secure and diverse income, and conservative approach, means it deserves a higher rating than it currently gets.

FINANCIALS AND VALUATION

At the current price of 126p, McKay is valued at £59m.

Net assets were £75m on 30 September 2010, while the company's property portfolio was valued at £206m.

Year ended 31 Mar	2007	2008	2009	2010
Sales (£m)	20.3	23.0	23.5	20.0
Pre-tax profits (£m)	57.5	8.4	-100.9	15.4
Adjusted eps	14.6p	18.1p	20.3p	13.0p
Dividend per share	11.0p	14.3p	14.2p	8.2p

In its last financial year, McKay managed to increase its NAV and to pay a total of 8.2p in dividends. This payout was down on the previous year, but then the share price was markedly higher then. An interim dividend of 2.7p per share was announced in late November, unchanged on the previous year.

Gross rental income last year was £17.1m, and net income from investment properties was £15.6m. Over 60% of contracted rents were paid by tenants with the highest Dun and Bradstreet credit rating, while 66% was payable by tenants with a net worth in excess of £15m. The portfolio void (by market rental value) was 11.6%.

The likely yield going forward is educated guesswork at the time of writing. Based on the last full year, the gross dividend yield stands at 6.5%. As a REIT, McKay is required to pay out 90% of its property income, as calculated for tax purposes.

McKay's actual income is well in excess of the payment, so the dividend should increase once confidence returns. I reckon McKay's valuation is really all about income – and the perception of likely future income which gives us the market's estimation of capital value at any given time.

RISKS

The main financial risk for a REIT is compliance with covenants on bank borrowing. With McKay, its loan-to-value at the end of September stood at 43.8%, against a covenant of 60% so the company looks safe at present on this score. However, any commercial property company runs the risk of tenant defaults and associated liquidity problems. The total loan facilities available to McKay are £185m, and its net debt level at the end of September 2010 was £90m.

If the economy slips back into recession, then this could hurt McKay's occupancy rates, NAV and, therefore, ultimately mean it breaks its banking covenants.

WHEN I'D SELL

This all depends on timescales. Over time, I expect the discount to NAV to narrow markedly, as confidence returns to the commercial property market, particularly for perceived quality players like McKay.

Simultaneously, I expect NAV to increase gradually and the dividend to do the same. I'll probably sell when the yield no longer makes McKay a lucrative investment. Based on the historic dividend and prevailing interest rates, a rise in price to around 220p would tempt me to exit.

THE FOOLISH BOTTOM LINE

McKay's currently depressed price looks like an excellent opportunity for income-seeking long-term investors to capitalise on a contrarian market opportunity – with a decent amount of downside protection, if things don't work out as planned.

Anyone searching for out and out fireworks should look elsewhere. But McKay could be an excellent bet for steady investors. During the years to come, I expect the dividend yield may return to a level which will make the current share price look unfeasibly low.

Disclosure: *As of 12 November 2010, David Holding held shares in McKay Securities.*

NCC Group: Steady Growth at a Reasonable Price

BY OWAIN BENNALLACK

NCC GROUP

LSE: NCC
Market: Main
Headquarters: Manchester
www.nccgroup.com

FINANCIAL SNAPSHOT

Recent Price: 508p
Buy Guidance: 520p
Market Cap: £173m
Net debt (18/10/10) £22m
(Price data as of 12/11/10)

WHAT IT DOES

NCC Group's activities include escrow, which enables firms to lodge software code remotely in case of disputes, and various other computer security and testing services.

WHY BUY

- Low rating compared to track record and prospects
- Successfully growing via acquisition
- Significant recurring revenues underpin the outlook
- Expansion into North America could boost growth

The UK has always punched above its weight when it comes to technology. Yet despite Brits inventing everything from computers and radar to the World Wide Web, we're short on listed technology firms.

According to the cognoscenti, the reason we don't have more companies like ARM and Autonomy is that, while we're great at innovation, we're not very good at the nuts-and-bolts of building a profitable business.

But NCC Group might have something to say about that. Its escrow and security testing services are hardly blue sky, yet it's a growing small cap that's a big deal in its niche in Europe.

Next stop: the world?

ABOUT THE COMPANY

NCC was founded in 1999. After a management buyout in 2003 led by Rob Cotton – who remains chief executive – the company floated on AIM in 2004, joining the main market in 2007. Along the way it's made multiple acquisitions, broadening the services it offers.

These activities are split across numerous subsidiaries, divided into two units as follows:

Escrow and software verification – Many companies rely on third-party software they don't own or control. By agreeing with their suppliers to lodge the relevant code in NCC's digital vaults, they reduce the impact of a bankrupt supplier or a legal dispute.

Assurance – A wide range services related to ensuring the integrity of computer systems and websites, whether through security testing (including 'ethical' hacking) or performance and load testing.

NCC Group currently has 430 staff. It claims to have 15,000 clients globally, including numerous FTSE 100 companies.

I think the jewel in NCC's crown is its recurring revenues. In the past year, Escrow saw 88% of all contracts renewed, while 89% of the load testing and performance revenues were renewed and are recurring. This gives the company great visibility over earnings and cash flow.

INVESTMENT THESIS

I like NCC Group for its predictable revenues, strong management, unglamorous business sector, and excellent record of growing value for shareholders.

The performance since 2004 says it all. The company's figures indicate earnings have increased steadily at an annual compound growth rate (CAGR) of 22%, while the dividend has soared 330%, from 2.5p per share to 10.75p – a CAGR of 34%.

Growth has moderated recently – but we have just been through a steep recession. Profits are still up 18% in the past financial year, with the dividend 16% higher. Analysts expect decent growth in the next 12 months.

As of 5 July, £35 million of renewals and orders were already forecast for the year. That's significant, given total group revenue for last year was £54 million. While NCC Group is no utility, I believe its predictable performance does put it more towards that end of the riskiness spectrum than its small market cap and tech sector membership might suggest.

This makes the forecast P/E rating too low, in my opinion. In addition, NCC could be an attractive target for a larger IT firm.

FINANCIALS AND VALUATION

I think NCC Group is the very definition of Growth at a Reasonable Price (GARP), with the company not looking too dear in terms of its historical figures, and good value on its prospects.

Here is its record over the past four years:

Year ended 31 May	2007	2008	2009	2010
Sales (£m)	25.4	35.7	46.8	53.7
Adjusted pre-tax profits (£m)	8.1	10.5	12.3	14.5
Adjusted eps	16.8p	22.4p	26.1p	29.7p
Dividend per share	4.75p	7.0p	9.25p	10.75p

As I write the shares are 508p, on a historical P/E of just over 17. Looking at the forecasts for 2011 and 2012, analysts foresee around 36.8p for this year, rising to 41.3p for 2012. So, what price for this growth?

Year ending 31 May	2011	2012
Forecast EPS	36.8p	41.3p
EPS growth	33%	12%
Prospective P/E	13.8	12.3
PEG ratio	0.4	1.0

The P/E is forecast to fall significantly in the next 12 months, and to fall again in 2012. The PEG ratio, which evaluates how highly-rated growth prospects are, is a very low 0.4. Jim Slater, who popularised the PEG ratio, sees anything under 1 as worth investigating, and under 0.75 as a potential bargain.

RISKS

Of course, we should not look at a ratio like the PEG in isolation. It might indicate a one-off spike in earnings, a cyclical recovery, or growth bought through unsustainable expenditure.

I've already been reassured by NCC Group's steady growth over recent years. But will this continue to be sustainable growth? NCC had been paying down debt, and had aimed to be debt-free by August 2010. However, with the acquisition of US security firm iSec, debt leapt to £22 million. The company's renewed facilities enable it to borrow £35 million.

Such debt isn't overly onerous, in my view, given operating cash flow of £19 million last year, and £16 million the year before. But there's not much to protect the downside – most of the assets are goodwill. On that note, NCC has a strong record with acquisition, but acquisitions are always risky and we can expect more to come.

Also, whereas I suspect Escrow scales well, growth in the Assurance business is likely to be labour intensive. Indeed, the company says recruitment and staff retention is the biggest challenge to growth. This could increase costs and hit margins, as well as encouraging more takeovers.

I used to worry Escrow would easily be undercut, but competition seemingly hasn't hurt NCC yet. The company has suggested that intangibles like reputation and legal know-how are a barrier to entry, rather than technology.

WHEN I'D SELL

One reason to sell might be a re-rating. By my reckoning the share price could roughly double on that measure, assuming growth continues as it has.

A big drop in recurring revenues would be a less welcome reason to reconsider owning NCC, and I'd obviously look out for growth moderating. Debt and margins should be monitored, too. Finally, if the CEO left I'd probably sell, given the execution risk in those acquisitions.

THE FOOLISH BOTTOM LINE

Small cap growth investing isn't in vogue, but there have been periods in the past when NCC Group would have got investors as excited as gold or an oil strike. Buy now, and in my view you can enjoy the ride with a good value ticket, while waiting for the wider market to get on-board.

Disclosure: *As of 12 Nov 2010, Owain Bennallack owned shares in NCC Group.*

GKN:
An Industrial Blue Chip Recovering Well

BY MALCOLM WHEATLEY

GKN

LSE: GKN
Market: Main
Headquarters: Redditch
www.gkn.com

FINANCIAL SNAPSHOT

Recent Price:.......................175.9p
Buy Guidance:.....................250p
Market Cap:...................... £2.7bn
Net debt (30/09/10)............... £212m
(Price data as of 12/11/10)

WHAT IT DOES

GKN is a diversified manufacturer supplying the world's leading automotive, off-highway and aerospace manufacturers with components, systems and services.

WHY BUY

» Strong underlying business
» Recovering markets and finances
» Reduced cost base and lower break-even point
» Attractive valuation
» Dividends resumed

ABOUT THE COMPANY

250 years old in 2009, GKN is one of just two original constituents of the UK's oldest stock market index, the FT30, to survive in their present form.

No longer the Guest, Keen & Nettlefold that was famous for its nuts, bolts and screws, GKN today is a diversified global engineering business, employing approximately 39,000 people in more than 30 countries worldwide.

The company's activities fall into four broad categories:

- Drive shaft and gearbox systems and components supplied to the world's automotive manufacturers.
- Powder metallurgy component manufacture for industrial and automotive markets.
- Drive-line and wheel production for manufacturers of construction, agricultural and mining equipment.
- Manufacturing airframe and engine component and sub-assemblies for both military and civil aerospace markets – including wing production for several Airbus aircraft.

INVESTMENT THESIS

GKN had a torrid recession as its main markets slumped in 2008/9. Pre-tax profits dropped from £199m in 2008 to a loss of £130m in 2009, eventually leading to the cancellation of 2008's final dividend, and the suspension of dividends throughout all of 2009.

With net debt at the end of 2008 standing at £708m, this move was prompted by the need to conserve cash and fund a required restructuring, said management. The company's share price – which had peaked at 412p in June 2007, as the credit crunch began – collapsed to 57p by 9 March 2009, a fall of some 86%.

Yet by the time the company published its final results for 2009, it was able to report that the tide had turned.

Restructuring had achieved a 20% reduction in the break-even points of its businesses, eliminating 7,000 jobs and 15 facilities; the aerospace business was performing well with new contract wins and the acquisition of Airbus' Filton wing-manufacturing facility; and automotive production had improved as global vehicle production increased.

Helped by a £423m rights issue, net debt was down to £330m; free cash flow was once again positive at £136m; and markets were recovering. Dividends would resume in 2010, added the company.

GKN, in short, is a recovery stock. Some of that recovery is already priced into the shares; at 176p, they have significantly outstripped the wider FTSE 100 index over the period since March 2009.

Even so, with the trading position continuing to improve, and dividends resumed, the shares change hands at just half their 2007 level, adjusting for 2009's six-for-five rights issue.

FINANCIALS AND VALUATION

According to the trading statement published on 19 October, net debt has continued to reduce. Totalling £212m at the end of September, it was expected to be below £200m by year end.

And half-yearly results published in August 2010 confirm that the anticipated recovery in the company's fortunes is indeed underway.

Half-year sales of £2.7bn generated a pre-tax profit of £175m, a significant improvement on 2009's half-year £6m loss. Similarly, half-year eps of 9.6p contrasted sharply with last year's loss of 0.3p.

Dividends were resumed with the payment of a 1.5p interim dividend. Medium-term dividend policy will be progressive, said the board, and will be based on an underlying ratio of around 2.5 times earnings cover.

Consensus forecasts of a 2010 full-year eps of 16p and a dividend payout of 4.1p place the business on an undemanding P/E of 11, yielding 2.3%.

For 2011, the prospective P/E and yield are 9 and 3.4% respectively.

With its markets and finances recovering well, I believe GKN's shares are too lowly rated. A 2011 P/E of 15, for instance, would see the company's shares changing hands for 293p, a 66% premium to 12 November's price.

Year ended 31 Dec	2006	2007	2008	2009
Sales (£bn)	3.6	3.9	4.4	4.2
Pre-tax profits (£m)	182	199	-130	-54
Adjusted eps	20.3p	23.7p	23.7p	5.5p
Dividend per share	8.6p	9.1p	4.5p	0.0p

RISKS

As 2009 starkly demonstrated, GKN is strongly focused on a handful of industries that are either cyclical (such as construction and agriculture), or dependent on consumer sentiment, such as automotive.

To this extent, the recent re-focusing on aerospace is welcome, yet still leaves the business potentially very vulnerable to a second recessionary economic environment – the so-called 'double dip'. At the time of writing, this seems unlikely, but can't be discounted.

More worryingly, given the company's age and antecedents, its pension obligation must also be considered. Taken together, the funding deficit of all its various schemes – within the UK and abroad – as at 30 June 2010 was £764 million. This is equivalent to 29% of its market value.

However, the pension position is improving, and management are putting in place measures to reduce the deficit, close funds to future accrual, and reduce promised inflation-linked obligations.

In the six months to 30 June 2010, the company's total pension deficit fell by 23%.

WHEN I'D SELL

Clearly, a material worsening of either the company's markets or pension situation would be counter to the outlined investment thesis. At which point, a sale might be considered.

But assuming that the recovery in the company's fortunes continues, a medium-term price of 300p or so – equivalent in today's terms to a P/E of around 15 – would see much of the present value outed.

The company will issue its full-year results on 1 March 2011, and its view of forward trading conditions and the level of the final dividend for 2010 will be keenly awaited.

THE FOOLISH BOTTOM LINE

GKN is a solid global manufacturer, recovering from a recession-induced slump in its fortunes. No business is perfect, but I think it pushes a lot of the right buttons.

Conservatively-managed, with a blue chip customer base and global reach and reputation, GKN offers very reasonable prospects of capital growth while simultaneously paying investors a rising dividend.

Disclosure: *As of 12 November 2010, Malcolm Wheatley held shares in GKN.*

Mothercare: Tell Us a Growth Story

BY G A CHESTER

MOTHERCARE

LSE: MTC
Market: Main
Headquarters: Watford
www.mothercareplc.com

FINANCIAL SNAPSHOT

Recent Price: 524.5p
Buy Guidance: 560p
Market Cap: £463m
Net debt (09/10/10)..................£9m
(Price data as of 12/11/10)

WHAT IT DOES

Mothercare is a retailer and wholesaler of products for mothers-to-be, babies and children.

WHY BUY

- Strong balance sheet
- Contrarian nature (sector out of favour)
- Business attuned to emerging markets demographics
- Proven international expansion model

Mothercare will be celebrating its 50th birthday in 2011. Its original vision, to provide 'Everything for mother and her baby under one roof', remains intact, though, as the chairman pointed out in the company's last annual report, the roof in question is now as likely to be in Mumbai or Moscow as in Manchester.

The share price is currently depressed, as the market focuses more on the near-term headwinds facing Mothercare in Austerity UK, than on the exciting opportunities in emerging markets where favourable demographics will, I believe, turbo-charge the company's growth for many years to come.

ABOUT THE COMPANY

The Mothercare group consists principally of two iconic brands: Mothercare itself and Early Learning Centre, which was acquired for £85m in 2007. The group also owns an internet social networking site for parents and parents-to-be, Gurgle.com, and recently acquired the maternity-wear brand Blooming Marvellous, further enhancing its offering across the parenting and pre-parenting spectrum.

The group can usefully be analysed in terms of geography and routes to market, which, in the last full financial year, broke down as follows:

Division	UK retail	UK direct	UK wholesale	International	Total
Revenue (£m)	459	127	5	176	766
Growth 2009/2010	-2%	+18%	+78%	+22%	+6%

Figures extrapolated from 2009 and 2010 Annual Reports

UK retail, the largest segment, accounting for 60% of group sales, is in the process of transformation. The aftershocks of the credit crunch are actually assisting Mothercare in this process, with weak property prices coinciding with a favourable lease expiry profile to enable it to close under-performing stores and renegotiate rents downwards on others.

At the same time as rationalising its High Street operation, the company is rolling out its more profitable out-of-town Parenting Centres. These 'true destination stores' hold the full range of Mothercare and Early Learning Centre products, as well as other retail offerings, such as Clarks' shoes and baby photography concessions.

The UK direct segment, which accounts for over 20% of all UK sales, has seen double-digit annual sales growth through the recession – testament to the group's continuing development of e-commerce, in which it describes itself as having been in the vanguard.

Wholesale has so far been a small contributor to sales, but the company sees significant growth potential here. A new partnership with Boots UK to provide childrenswear for its 400 stores has recently been launched, while sales of Mothercare-branded toiletries through third-party retailers have been successfully trialled at home and abroad.

In my view, Mothercare rightly sees its fourth distribution channel – international franchising – as the single largest growth opportunity for the group. The relatively

low risk/low capital expenditure franchise model of international expansion has seen the company penetrate more than 50 countries with over 800 stores. In India and China it also owns 30% of the franchise companies, earning a 30% share of the net joint venture profits in addition to the royalty on retail sales of the regular franchise structure.

Total international sales have recently exceeded UK sales for the first time, with Mothercare's cut now representing nearly a quarter of group revenues and 40% of profits.

INVESTMENT THESIS

When the world's top retailers met for their annual congress in October 2010 there was broad agreement on what would mark out successful retailers of the future. Some of the key characteristics were:

- a multichannel offering with strong brands;
- stores which engage with customers and make their hearts beat faster;
- a strong online presence including building relationships with consumers through social networking; and
- a viable strategy for establishing the brand in high-growth emerging markets.

Mothercare's business model could almost have been held up as a blueprint.

Meanwhile, in the short term, retailers are out of fashion with investors – and within the sector Mothercare is a laggard. The FTSE All-Share index is up 10% over the past 12 months, while General Retailers are down 7% and Mothercare is down 15%.

The market has been fretting all year about the UK consumer in the face of government austerity measures. In the case of Mothercare, those general worries have been compounded by anxieties about tough competition from supermarkets on childrenswear and the recent trialling by Tesco of a specialist baby shop within one of its stores.

For many analysts and investors, the near-term UK negatives seem to have eclipsed Mothercare's exciting international growth potential. However, I take heart from the fact that Aberdeen Asset Management – a group with renowned expertise in Asia-Pacific markets – has increased its shareholding in Mothercare during the last six months from 8% to 11%.

FINANCIALS AND VALUATION

Despite the global recession, Mothercare has delivered top-line growth and a better earnings-per-share (EPS) performance than many of its retail peers, while generous annual dividend increases are an indication of the Board's continuing confidence in the company.

Year ended 31 Mar	2007	2008	2009	2010
Sales (£bn)	499	677	724	766
Pre-tax profits (£m)	18.9	4.5	42.0	32.5
Adjusted eps	24.2p	34.5p	32.0p	31.5p
Dividend per share	10.0p	12.0p	14.5p	16.8p

Earnings have been underpinned by excellent cash generation and, despite heavy capital expenditure over the past couple of years, net cash on the balance sheet has been rising. A sizeable pension deficit lurking in the background isn't ideal, but it wouldn't keep me awake at night.

Mothercare's shares trade on a price/earnings (P/E) multiple of something more than 15 times analysts' current-year earnings forecasts, and 13 times next year's. For a company with Mothercare's level of emerging markets exposure, a prospective P/E of 13 doesn't look too demanding.

Furthermore, EPS growth for 2011/12 is forecast to be in the high teens, giving an attractive PEG factor of around 0.7. Just for good measure, a forecast current-year dividend yield of 3.5%, rising to 4% next year, isn't to be sniffed at either.

Mothercare released its half-year results in mid November and these didn't contain any unwelcome surprises. The company confirmed it remained on track to open 150 stores this financial year and raised its interim dividend by just over 16%.

RISKS

Any new economic downturn would not, of course, be welcomed by retailers, whose revenue is on the front-line of economic activity and is undoubtedly vunerable to the influence of macroeconomic factors. That said, at least Mothercare has very little debt on its balance sheet.

Net debt as of early October 2010 was just £9m, which compares to borrowing facilities of £40m (which run through to October 2013) and a £10m overdraft facility. The emphasis on international expansion could also be a risk. Many UK retailers have become unstuck when they ventured overseas.

WHEN I'D SELL

I see Mothercare as a long-term growth story and if I decide to invest – my finger is still hovering over the buy button! – it will be on that basis.

Taking a shorter-term view, a fair value PEG factor of 1 would suggest a share price target of a bit above 700p by this time next year if analysts' current forecasts remain unchanged.

THE FOOLISH BOTTOM LINE

With its shares depressed by the prevailing poor sentiment towards the UK retail sector, Mothercare looks a tempting contrarian bet for 2011 and beyond.

RISK WARNING

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The shares mentioned may not be suitable for any individual.

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ABOUT MOTLEY FOOL SHARES 2011

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