

SARACEN

share success

What do we look for in an investment?

When we visit potential shareholders, one of the first questions that tends to be asked is 'what do we look for in a company?' We look for a number of different characteristics but I thought it would be useful to share these.

Before looking at the financials of a company to determine whether it fulfils our criteria, I first of all look at the industry in which it operates. Every fund manager has their favourite companies/industries and each will be positively or negatively inclined towards particular areas although they may not admit to this!

I have a wish list for companies including:

- **Market leading positions**
- **Self-funded roll-out stories**
- **Unique assets**
- **Sustainable margins**
- **Long-term visibility**

Not every investment (in fact very few if any) will have all these attributes but if a company possesses some of them I will analyse them in more depth by using our detailed financial template. The template consists of P&L, balance sheet and cash flow analysis and as well as looking at historical numbers, we forecast what we believe can be achieved over the next five years. In addition to a central case scenario we forecast a best and worst case scenario in order we can more accurately analyse potential outcomes.

An important characteristic which Saracen looks for in a company is a strong balance sheet as this gives flexibility going forward. If economic times worsen or sales growth slows, it is crucial that our investments have the ability to continue to meet their obligations. In many ways, it is exactly the same situation as an individual or household faces. No-one would feel comfortable if they borrowed outwith their means as there could be a change in personal circumstances such as unemployment or illness. We view investments in exactly the same way; the more headroom they have, the greater the number of options available to them.

Most importantly, we look at free cash flow which is generated by a business. It is relatively easy for organisations to manipulate EPS figures through, for example, exceptional items or pension issues but it is impossible to hide the cash. We monitor the return on capital and in essence we view a company as no more than 'a sausage machine'. For us it is about how much capital goes in one end and how much comes out the other. Whether the company is a producer of widgets, a wealth manager or an aerospace company it is in many ways irrelevant, what is crucial is the return it makes on its capital.

If a company has a high and sustainable free cash flow yield, then it has a number of options of what it can do with the cash. If it has debt it can pay this down (or ahead of schedule). It can, perhaps, return it to shareholders via an increased level of dividend or a share buyback. We prefer, however, that the company reinvest the cash in order to provide further growth in future years. Of course, a combination of the above is never a bad starting point!

Companies by their very nature have capital expenditure commitments, whether maintenance or growth capex but we prefer investing in those which have a lower requirement. The less investment needed, the higher the free cash available for shareholders.

Market leading positions. We are attracted to these companies when looking for potential investments for the portfolio. There are many advantages for such companies, but central to these are the importance they have to their suppliers and the power they wield. For example, a new stock in the portfolio is Howden Joinery, a business which has 20% market share yet is double the size of the numbers 2 & 3 players added together. Howden can use its purchasing power to help drive returns. Companies with strong market positions tend to have higher margins.

Self-funded roll-out stories. These models appeal to us for many reasons. Firstly, the management has a timescale and vision in mind for growth and secondly they are using the cash flows of the business in order to achieve this. An example within the portfolio is Dunelm Group, the UK's largest homeware and soft furnishings store, with management targeting a store roll-out of between 10-15 per annum.

Unique Assets. SGF owns Elementis in the portfolio and the company has to all intents and purpose a unique asset as it owns the only significant mine of hectorite in the world. Hectorite is a crucial ingredient in the manufacture of rheology additives, or in plain English, is an additive which goes into the production of paint to help in the consistency of the product. Although there are alternatives, none are as effective as hectorite and the company has the top 25 paint producers in the world as customers.

Sustainable Margins. It is always rewarding to be able to invest in companies where there is a probability margins can increase over time. Weir Group has shown it is possible to increase margins by servicing growing industries and increasing the number of industries into which it sells. The company has successfully targeted the mining and oil & gas industries by firstly selling its equipment but then, more importantly, providing the spares and maintenance for the goods. The margins earned on the spares and maintenance far exceeds the initial sales and as many of the projects are 10 years plus, there is a steady income stream generated.

Long-term Visibility. We like our investments to have long order books. The longer the visibility, the less chance there is of a negative surprise. Mears Group, the social housing repairs and maintenance provider, is one such company. Their aim is to secure long-term contracts for repairs and maintenance work, capital works and domiciliary care. It is usual for the company at the beginning of the year to have upwards of 80% of forecasts already secured, limiting their risk of reporting disappointing figures.

It is all well and good talking about what we look for when analysing a potential investment but it is crucial that the company has a sensible rating which can expand or at the very least be maintained. We have identified companies recently which appeal for a variety of reasons but feel it has already been reflected in the rating. Examples include Domino's Pizza UK & Ireland and Aggreko. These companies are on our radar screen but we will not invest until the rating falls to a more attractive level.

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