Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope users

19th May 2017

Market overview

No.	Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
1	FTSE 100	7436.42	▲0.674	▲4.04	▲20.6	7522.03	5923.53	16/5/17	14/6/16
2	FTSE 250	19691.6	▼-0.526	▲2.04	▲16.6	19876.8	14967.9	10/5/17	27/6/16
3	FTSE SmallCap	5573.5	▼-0.666	▲2.27	▲22.2	5632.03	4272.07	16/5/17	27/6/16
4	FTSE AIM 100	4817.43	▼-0.0195	▲4.7	▲42.5	4849.54	3188.77	16/5/17	27/6/16
5	S&P 500	2357.03	▼-1.56	▲0.634	▲15.1	2402.32	2000.54	15/5/17	27/6/16
6	UK Treasury 10 Year Par Yield	1.12	▼-4.27	▲8.74	▼-26.3	1.55	0.61	24/5/16	12/8/16
7	Brent Oil Spot $	$52.09	▲2.57	▼-4.97	▲7.31	$56.965	$41.965	29/12/16	2/8/16
8	Gold Spot $ per oz	$1260.35	▲2.88	▼-2.24	▼-0.0159	$1366.48	$1128.22	6/7/16	15/12/16
9	GBP/USD - US Dollar per British Pound	1.30088	▲0.932	▲1.28	▼-10.9	1.47895	1.20401	22/6/16	16/1/17
10	GBP/EUR - Euros per British Pound	1.1691	▼-1.45	▼-2.35	▼-10.1	1.3174	1.1066	25/5/16	13/10/16

We've seen another week of record highs on the markets although Thursday saw most of those gains wiped off in the UK. My portfolio has been going up in value seemingly every day for no apparent good reason. I have high quality shares on fairly punchy valuations that are up 10% during the last week with no news flow.

This is obviously not unpleasant from a financial point of view but I am not getting carried away. The market can take away a capital gain as quickly as it gives it. However, this kind of euphoria is typical of a bull market and people need to be mindful of it in my view.

Company earnings reports from decent businesses seem to be satisfactory but I still think that there is a danger that current gains from the fall in the value of the pound since last summer could be being seen as genuine real growth. From July onwards, this currency effect is likely to weaken and could see some companies struggle to grow.

Top 10 FTSE All-Share winners

No.	TIDM	Name	%chg 1w
1	SEPU	Sepura PLC	▲35.1
2	NANO	Nanoco Group PLC	▲25.4
3	BRSN	Berendsen PLC	▲22
4	NCC	NCC Group PLC	▲20.1
5	SOPH	Sophos Group PLC	▲16.2
6	ERM	Euromoney Institutional Investo...	▲13
7	OCDO	Ocado Group PLC	▲9.8
8	TALK	TalkTalk Telecom Group PLC	▲9.52
9	BOOT	Boot (Henry) PLC	▲9.06
10	CNE	Cairn Energy PLC	▲9.02

Top 10 FTSE All-Share losers

No.	TIDM	Name	%chg 1w
1	PFC	Petrofac Ltd	▼-18.8
2	MAB	Mitchells & Butlers PLC	▼-12.7
3	BTG	BTG PLC	▼-11.5
4	PFD	Premier Foods PLC	▼-10.4
5	LMI	Lonmin PLC	▼-9.47
6	FENR	Fenner PLC	▼-8.7
7	SPT	Spirent Communications PLC	▼-8.24
8	TED	Ted Baker PLC	▼-8.14
9	VEC	Vectura Group PLC	▼-7.51
10	EVR	Evraz PLC	▼-7.31

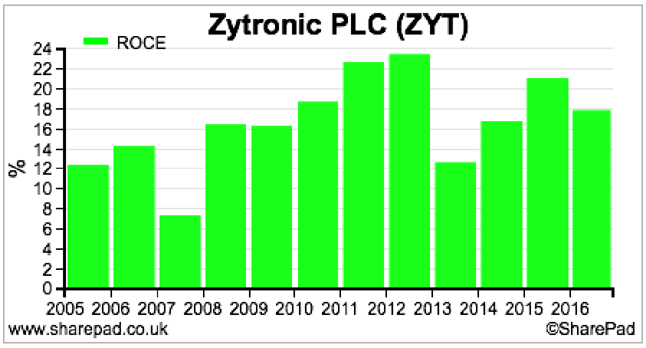
Share Discussion: Zytronic (AIM:ZYT)

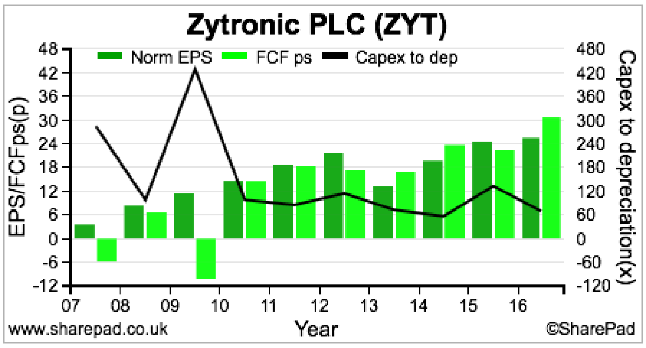
Unless you are a small companies investor then it's quite possible that you've never heard of Zytronic, the Newcastle-based specialist touch sensor business. But, you've probably used one of its products without knowing it.

The company uses its patented glass technology to make niche, specialised and highly durable touch sensor applications that are increasingly used in everyday life - machines using touchscreen technologies such as:

- ATMs
- Vending machines
- Roulette tables
- Slot machines
- Ticket machines
- Secure entry systems

The company looks as if it is a reasonable business on the basis of its historic performance. It has been able to produce reasonable - albeit volatile levels – of ROCE which is a good sign, even though it is down on levels seen a few years back. The recent trend has been good following a profit setback in 2013.

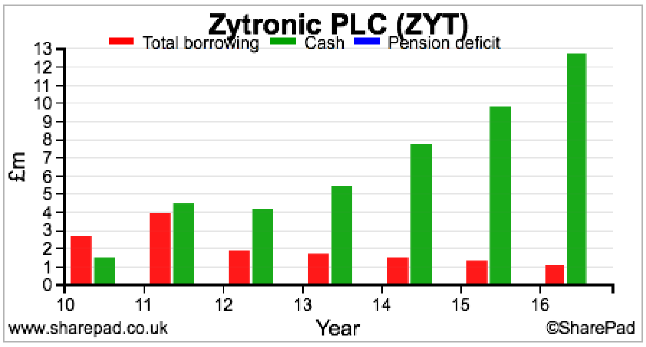




Zytronic is also good at turning most of its profits into free cash flow. Throw in a debt-free balance sheet and you have a company that is worthy of closer scrutiny.

Virtually all the company's sales are exports which means it has been a beneficiary of the fall in the value of the pound which has made its products more price-competitive. The company does hedge its currency exposure though which has blunted this effect on its financial results.

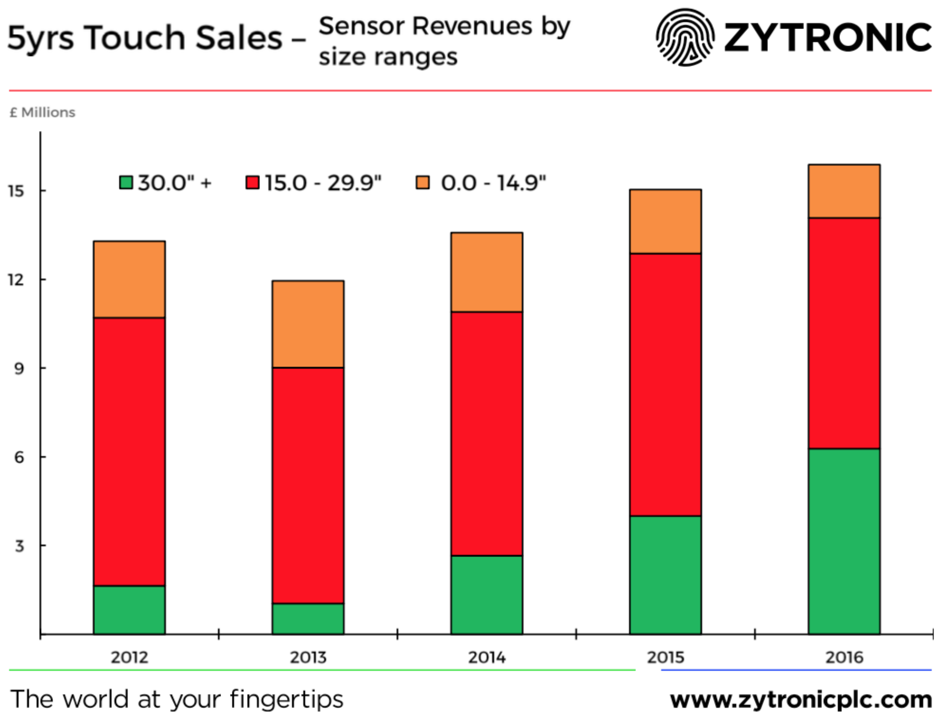
That said, this week's interim results make for happy reading for the company's shareholders. Sales were up by 14.1% which fed through to a

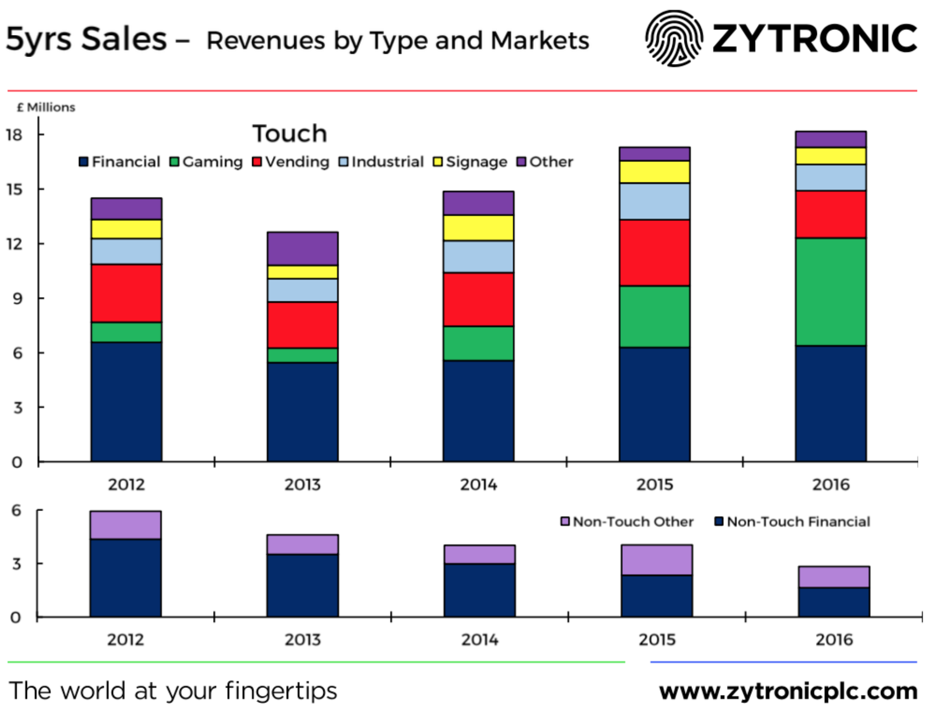


38.9% increase in pre-tax profit and a 43.1% increase in diluted earnings per share (EPS).

Zytronic is seeing some nice profit margin improvements coming through from changes in the sales mix of touch sensors business. Bigger screens generate better profit margins and business is being driven by increased sales from the gaming sector for things such as large, interactive roulette tables.

The screenshot below, taken from the company's results presentation, shows the healthy trend in growth from larger size ranges during the last five years. The company will be hoping that it continues going forward. Note the trend in smaller sized ranges which perhaps reflects an increase in competition in that sector of the market. Volumes from this segment declined by 18% in H1 whereas medium sized grew by 10% and large by an impressive 39%.





Sector	H1 17 Sales	%	YOY growth
Financial	£3.1m	31%	14.8%
Gaming	£3.6m	36%	38.4%
Vending	£1.6m	16%	23.1%
Industrial	£0.9m	9%	12.5%
Signage	£0.4m	4%	-20%
Other	£0.4m	4%	0%
Total	£10.0m	100%	20.5%

You can also see how significant the gaming sector has become to Zytronic. It is now its biggest sector, accounting for nearly 40% of touch sales. Only signage has seen a poor sales performance recently.

One of the reasons why Zytronic's share price reacted so well on the day of its interim results was due to the expectation of profit forecast upgrades by City analysts. Beforehand, current expectations for the year to September 2017 were for sales of £21.9m and EPS of 28.6p.

One of the most useful things you can do with a set of interim results is calculate the trailing twelve month (TTM) profits (by adding H1 to last year's H2) and compare them with forecasts. We can see from the table on the following page that TTM sales are ahead of forecasts and are currently running at £22.5m with diluted EPS at 30.1p. As long as the trading performance is still on the up then you can safely assume that profit forecasts for the full year will have to go up.

Zytronic plc					
£ '000s	**H1 16**	**H2 16**	**FY 16**	**H1 17**	**TTM**
Turnover	9,868	11,219	21,087	11,281	22,500
cost of sales	-5,692	-6,379	-12,071	-6,414	-12,793
Gross profit	4,176	4,840	9,016	4,867	9,707
Distribution costs	-198	-180	-378	-229	-409
Administration expenses	-2,220	-2,145	-4,365	-2,117	-4,262
Trading profit	**1,758**	**2,515**	**4,273**	**2,521**	**5,036**
Finance costs	-12	-11	-23	-9	-20
Finance income	8	12	20	5	17
Profit before tax	**1,754**	**2,516**	**4,270**	**2,517**	**5,033**
Tax expenses	-271	88	-183	-366	-278
Profit for the period	1,483	2,604	4,087	2,151	4,755
EPS(p)	**9.5**	**16.6**	**26.1**	**13.6**	**30.1**
Operating margin	17.82%	22.42%	20.26%	22.35%	22.38%
Tax rate	15.45%	-3.50%	4.29%	14.54%	5.52%
Net profit margin	15.03%	23.21%	19.38%	19.07%	21.13%

You can create a custom financial table in SharePad to do the TTM analysis for you. See the table I've created below. Once you've set it up, you can use it for any company.

(At the moment, SharePad doesn't calculate some ratios for interim results but it will do in the future. Note that for the Net profit margin ratio I used Post-tax profit as a % of Turnover using the Combined item feature.)

Zytronic's income statement does have a few quirks that are worth noting.

Zytronic PLC (ZYT)				
← Prev Next →		2016		2017
Fiscal period ending	31/3/16	30/9/16	31/3/17	31/3/17
£ millions unless stated	Q2	Q4	Q2	TTM
TTM ANALYSIS				
Turnover	9.9	21.1	11.3	22.5
Cost of sales	(5.7)	(12.1)	(6.4)	(12.8)
Gross profit	4.2	9.0	4.9	9.7
Admin. expenses	(2.4)	(4.7)	(2.3)	(4.7)
EBIT	**1.8**	**4.3**	**2.5**	**5.0**
Net interest	(0.004)	(0.003)	(0.004)	(0.003)
Pre-tax	**1.8**	**4.3**	**2.5**	**5.0**
Tax paid	(0.3)	(0.2)	(0.4)	(0.3)
Post-tax	**1.5**	**4.1**	**2.2**	**4.8**
EPS	**9.6**	**26.1**	**13.8**	**30.3**
Operating margin	-	15.6	-	18.0
Tax rate (paid)	15.5	4.3	14.5	5.5
Net profit margin	-	19.4	-	21.1

The first is that it hedges its US dollar and Euro currency exposures where the hedge is marked to market. This is a rolling 6 month hedge which will reduce to 3-4 months by the September year end. The effect on profits was small in H1 - compared with a large effect last year - but I don't see the company getting rid of the hedge. That said, the rate it hedges at in the future has some scope to affect reported profits.

The other thing to note is the company's very low tax rate which was 14.5% in H1 and is currently running at 5.5% on a TTM basis. Clearly, if this tax rate was to increase then it could reduce the growth rate of EPS and have some impact on the share price. The company is benefitting from tax credits on research and development expenditure. It has also opted in to something called the Patent Box regime which allows profits on some patented products after April 2013 to be taxed at a rate of 10%. How long this effect will last is a little unclear as the company has to apply for the relief when it submits its tax return.

Zytronic's half year free cash flow performance was a little subdued due to a working capital outflow related to inventories and higher capex. I don't see this as a cause for major concern at the moment. Where sales are growing, the company can be expected to build inventories and invest in new assets. Stock levels should always be watched closely but it's too early to have any concerns in my view. There was still an inflow of cash during the first half of the year with net cash increasing slightly to £12.5m at the end of March.

£ '000s	H1 16	H2 16	FY16	H1 17	TTM
Operating cash flow	2,773	3,391	6,164	2,190	5,581
Tax paid	-234	-342	-576	-83	-425
Net operating cash flow	2,539	3,049	5,588	2,107	5,156
Capex	-408	-364	-772	-547	-911
Net interest	-4	3	-1	-3	0
Free cash flow	**2,127**	**2,688**	**4,815**	**1,557**	**4,245**

SharePad will show you the TTM free cash flow near the bottom of the Cash flow tab in the Financials view (*make sure you click the TTM button!*):

Zytronic PLC (ZYT)

← Prev Next →		2016		2017
Fiscal period ending	31/3/16	30/9/16	31/3/17	31/3/17
£ millions unless stated	Q2 IFRS	Q4 IFRS	Q2 IFRS	TTM
FREE CASH FLOW				
Net cash from operations	2.5	5.6	2.1	5.2
Capital expenditure	(0.4)	(0.8)	(0.5)	(0.9)
Dividends from joint ventures	-	-	-	-
Free cash flow for firm (FCFf)	2.1	4.8	1.6	4.2
Dividends paid to minorities	-	-	-	-
Interest paid	(0.01)	(0.02)	(0.008)	(0.02)
Interest received	0.008	0.02	0.005	0.02
Free cash flow for equity (FCF)	2.1	4.8	1.6	4.2

So Zytronic looks as if it is doing well. Volumes and sales values are expected to keep on growing whilst the mix effect of larger ranges is expected to keep on helping profit margins. It looks like a decent quality business to me.

At 472p, the shares trade on a TTM PE of 15.7 times. When you factor in the £12.5m of net cash (equivalent to 78.6p per share) it falls to just 13.1 times. That looks pretty good value, especially in comparison to sector peers such as FW Thorpe and XP Power. Then you throw in a nice dividend yield of 3.5% with a growing dividend and there's even more to like.

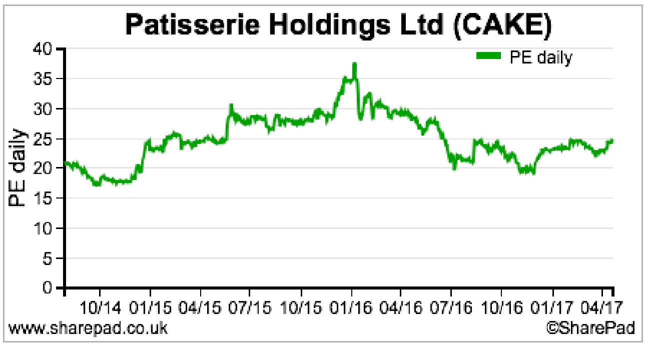
TIDM	Name	Market Cap. (m)	Close	fc PE	fc Yield	TTM EV/EBITDA	Lease-adj EBIT yield
MGAM	Morgan Advanced Materials PLC	£873.8	306.2p	15.0	3.7	9.6	7.7
OXIG	Oxford Instruments PLC	£620.7	£10.83	22.3	1.2	14.4	3.6
XPP	XP Power Ltd	£509.9	£26.50	21.4	2.8	15.5	5.6
TFW	Thorpe (F W) PLC	£442.5	382.5p			19.3	3.8
LUCE	Luceco PLC	£392.4	244p	24.6	0.8	20.3	4.2
DIA	Dialight PLC	£352.5	£10.84	30.4	0.7	21.1	2.9
TTG	TT electronics PLC	£330.8	203.75p	14.9	2.8	7.1	7.1
GHH	Gooch & Housego PLC	£322.6	£13.20	28.3	0.8	18.6	4.0
XAR	Xaar PLC	£292.3	375.25p	29.8	2.8	8.9	7.7
JDG	Judges Scientific PLC	£102.9	£16.825			16.8	1.2
SPRP	Sprue Aegis PLC	£92.9	202.5p	22.3	4.4	37.0	2.1
ZYT	Zytronic PLC	£75.4	472.5p	16.5	3.5	11.8	6.7

So why do the shares trade on a comparatively low rating? Is growth about to grind to a halt? Perhaps the low tax rate - which flatters EPS and the PE - is a concern? There's also the fact that the company is very reliant on key customers. In 2016 it derived 61% of its revenues from just three customers. That is a significant risk to any business. Zytronic counters this threat by arguing that customers tend to be sticky one its touch sensors are built into their products as it makes it hard to switch to another supplier. However, I can see why some investors would worry about this.

Share Discussion: Patisserie Holdings (AIM:CAKE)

Disclosure: Phil Oakley owns shares in Patisserie Holdings

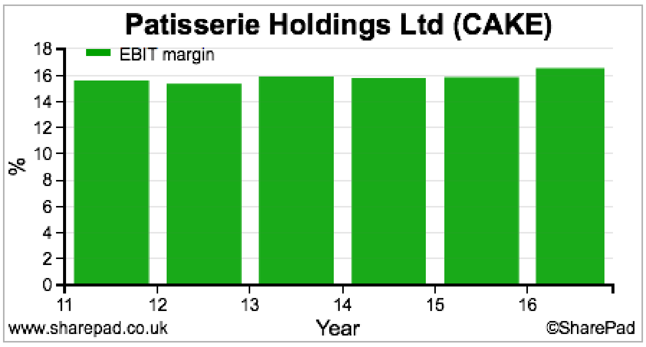
Patisserie Holdings' share price has largely moved sideways for the last two years. The company's shares have been derated (a lower valuation has been attached to them) as a period of euphoria about its potential profitability has calmed down.



Put simply, the valuation of the shares got too far ahead of its business performance and the profits needed some time to catch up with the share price. During this time, the company has not put a foot wrong and has delivered good growth in profits and cash flows as it has opened up more outlets.

I usually don't like investing in retail roll outs as they have a tendency to turn sour (see my article **Riding a retail roll out** for more on this interesting subject). Patisserie Holdings looks like an example of a very good roll out for a number of reasons.

Firstly, the company is making very impressive lease-adjusted returns on capital employed (ROCE) which are not being diluted by opening new stores. The ROCE is also underpinned by high operating margins due to its premium product offering of affordable cakes and sandwiches. I like high operating margins as they can be a sign of a strong business model whilst also offering protection against temporary profit setbacks.



Secondly, the retail roll out is still relatively immature. The company is currently trading from 192 stores with the scope to open up a further 250 in the UK and Ireland. In the current tough retail environment, Patisserie Holdings can access decent locations with very cheap rents or open up concessions in existing high street stores such as Debenhams.

Thirdly, and most importantly, the roll out is delivering impressive results. You are seeing the benefits of operational gearing, with higher margins and no drag on profitability from opening up new stores as seen in other roll outs. One of the main attractions of Patisserie Holdings is that its stores are profitable in the first week with the cash costs of the new shops paid back in just 23 months.

The fourth reason is the management team. The chairman, Luke Johnson has a great track record with developing cafes and restaurants as evidenced by his success at Pizza Express. His experience will be invaluable to Patisserie Holdings.

Half year results released this week showed that the roll out strategy is on track. Revenues increased by 11%, pre-tax profits by 15.7% and diluted EPS by 19.2%. This is the kind of operational gearing (profits increasing faster than sales) that you want to see.

The growth strategy has been largely based around the Patisserie Valerie format (posh cakes and sandwiches) where sales growth was 15.7% during the first half of the year but it is encouraging to see that a new Philpotts (high quality salads and sandwiches) was opened up as well - the first since the chain was bought in 2014.

Profit margins have seen a decent increase despite well-publicised wage pressures from the increase in the living wage and increases in ingredients costs due to the fall in the value of the pound. Wage costs have been kept in check by more effective staff rostering in stores with more to come later in the year as wage costs continue to increase. The company has stated that this has not had any damaging effects on customer service levels which is reassuring.

Patisserie Holdings Analysis					
£ '000s	**H1 16**	**H2 16**	**FY 16**	**H1 17**	**TTM**
Turnover	49,984	54,157	104,141	55,488	109,645
cost of sales	-10,825	-12,007	-22,832	-12,188	-24,195
Gross profit	39,159	42,150	81,309	43,300	85,450
Distribution costs	-30,774	-33,325	-64,099	-33,599	-66,924
Trading profit	**8,385**	**8,825**	**17,210**	**9,701**	**18,526**
Finance costs	0	-6	-6	0	-6
Finance income	0	0	0	0	0
Profit before tax	**8,385**	**8,819**	**17,204**	**9,701**	**18,520**
Tax expenses	-1,707	-1,762	-3,469	-1,756	-3,518
Profit for the period	6,678	7,057	13,735	7,945	15,002
EPS(p)	**6.61**	**6.99**	**13.6**	**7.88**	**14.87**
Operating margin	16.78%	16.30%	16.53%	17.48%	16.90%
Tax rate	20.36%	19.98%	20.16%	18.10%	19.00%
Net profit margin	13.36%	13.03%	13.19%	14.32%	13.68%

Here's the table I created in SharePad applied to Patisserie Valerie:

Elsewhere, costs are being well controlled. The rents at key stores have been agreed and a new supply agreement should help to increase margins during the second half of the year. Increases in business rates are not pushing up costs for the company.

One key competitive advantage that Patisserie Holdings has is that it is a vertically-integrated business. It is completely in control of its supply chain from owning its own bakeries to supply its shops and having its own logistics operations.

Patisserie Holdings Ltd (CAKE)				
Prev Next		2016		2017
Fiscal period ending	31/3/16	30/9/16	31/3/17	31/3/17
£ millions unless stated	Q2	Q4	Q2	TTM
TTM ANALYSIS				
Turnover	50.0	104.1	55.5	109.6
Cost of sales	(10.8)	(22.8)	(12.2)	(24.2)
Gross profit	39.2	81.3	43.3	85.5
Admin. expenses	(30.8)	(64.1)	(33.6)	(66.9)
EBIT	**8.4**	**17.2**	**9.7**	**18.5**
Net interest	-	(0.006)	-	(0.006)
Pre-tax	**8.4**	**17.2**	**9.7**	**18.5**
Tax paid	(1.7)	(3.5)	(1.8)	(3.5)
Post-tax	**6.7**	**13.7**	**7.9**	**15.0**
EPS	**6.7**	**13.6**	**8.0**	**14.9**
Operating margin	-	16.5	-	16.9
Tax rate (paid)	20.4	20.2	18.1	19.0
Net profit margin	-	13.2	-	13.7

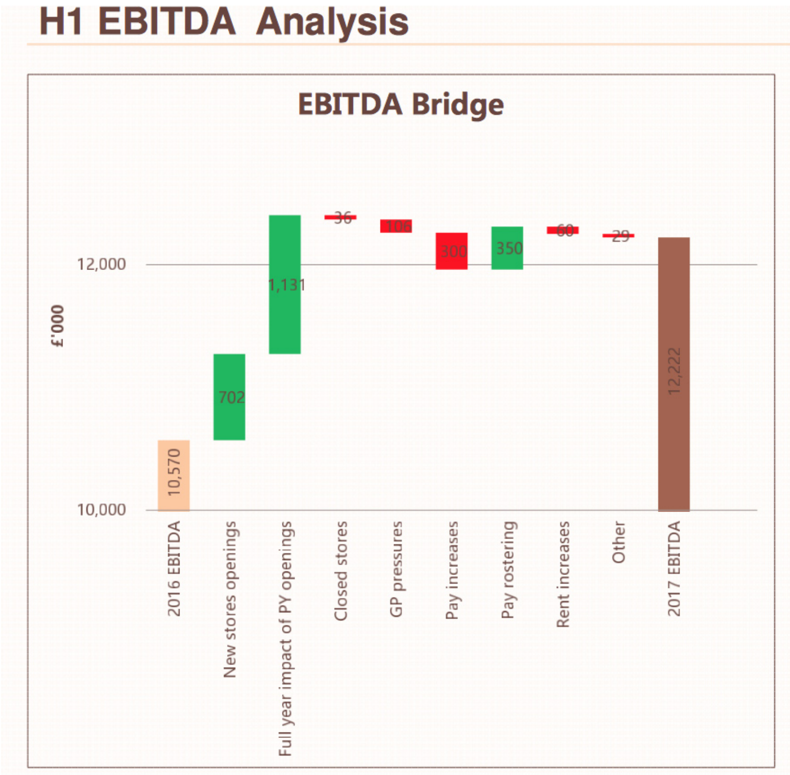
As the company continues to get bigger, it should be able to benefit from something known as scale economies which will come through in things such as better buying power with suppliers. This may be helpful to further profit margin increases.

The screenshot below is taken from the company's results presentation. It shows how costs are being controlled but also the impact from new stores. Note the significant contribution to profits from the full year impact of stores opened last year. This is the key benefit of a retail roll out and is the major source of profit growth along with new stores opened in the period.

The only small criticism I have of Patisserie Holdings is that it does not disclose the like-for-like sales of the existing stores (ones that have been trading for at least a year) as this is one of the key performance measures needed to weigh up the success - or otherwise - of a retail roll out.

The best retail roll outs are ones where the existing stores are still growing as well. As an investor, it's very easy to become fixated on the potential of opening up new stores but if this is masking a declining underlying business then trouble is often not far away.

Thankfully, there are other things you can do to check on the health of the underlying business in the absence of like-for-like sales information.



This approach is a bit rough and ready but you can work out the average sales and profits per store to see how they are trending. Sales numbers depend on things like the sales area and location (standalone shop or concession will have an impact here) but they are declining slightly. Profit per store is increasing which is a more comforting sign.

	Avg no of stores	Sales per store (£k)	EBIT per store(£k)
TTM	188	583,218	102,622
2016	175	594,857	102,200
2017	157	585,350	95,522
2018	128	598,438	92,516

Patisserie Holdings' cash flow performance remains good. Operating cash flow and free cash flow both increased year-on-year. There was a net cash inflow of £2.9m during the period, leaving the company with net cash balances of £16.2m with no debt.

Patisserie Holdings Ltd (CAKE)

← Prev Next →		2016		2017
Fiscal period ending	31/3/16	30/9/16	31/3/17	31/3/17
£ millions unless stated	Q2 IFRS	Q4 IFRS	Q2 IFRS	TTM
FREE CASH FLOW				
Net cash from operations	8.9	18.6	9.3	19.0
Capital expenditure	(4.4)	(8.7)	(4.4)	(8.7)
Dividends from joint ventures	-	-	-	-
Free cash flow for firm (FCFf)	4.5	9.9	4.9	10.3
Dividends paid to minorities	-	-	-	-
Interest paid	-	(0.006)	-	(0.006)
Interest received	-	-	-	-
Free cash flow for equity (FCF)	4.5	9.8	4.9	10.3

By renting rather than buying its shops, Patisserie Holdings is funding its expansion entirely from its cash flow. I expect this to continue going forward. Having said that, the company does mention in its results statement that it is on the look out for acquisitions to build the business.

If it does find a company to buy it will be interesting to see how it funds the purchase. An issue of equity is possible but this is nothing to worry about if a deal is sensibly priced.

Patisserie Holdings' is performing well but despite the derating of its stock market valuation over the last couple of years its shares are still not cheap by any means. Nor should they be in my opinion. It is a quality business with a good growth pipeline.

TIDM	Name	Market Cap. (m)	Close	fc PE	fc Yield	TTM EV/EBITDA	Lease-adj EBIT yield
CAKE	Patisserie Holdings Ltd	£320.0	320p	20.3	1.1	13.8	5.9

Sure, a further derating is possible but if the company can carry out its growth plans whilst maintaining the profitability of its existing assets then I think the shares can trend upwards over time broadly in line with earnings growth over the next few years.

I think there is a possibility that EPS forecasts for 2017 could nudge up a little given the progress on margins seen in the first half results, the reassuring message on costs and the lower tax rate. City analysts continue to see strong EPS growth over the next few years as shown in the graphic below from SharePad.

Patisserie Holdings Ltd (CAKE)

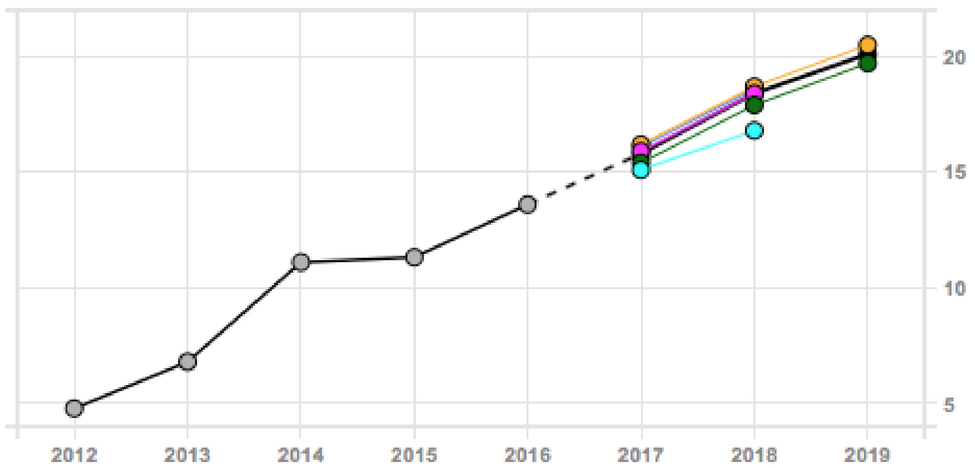
Key	Name	Forecast	Confirmed	Opinion	Target price
	Arden Partners	29/11/16	16/5/17	Buy	
	Canaccord Genuity Ltd	29/11/16	28/4/17	Buy	4.05
	FinnCap	1/12/16	16/5/17	Buy	3.50
	Investec Securities	15/2/17	10/4/17	Buy	4.00
	Peel Hunt LLP	13/2/17	12/5/17	Hold	3.62
	Consensus	5/5/17		Buy (5)	3.79

The actual number of estimates used to calculate the consensus opinion

Prev Forecasts for year 2017 Next

Key	Name	Profit	EPS	Dividend	Turnover	EBIT	EBITDA
	Arden Partners	20.1	16.1	3.5	115.0		25.0
	Canaccord Genui...	20.2	16.2	3.6	115.3	20.2	25.0
	FinnCap	20.0	15.9	3.3	115.0	19.8	24.8
	Investec Securities	19.5	15.4	3.2	115.8		24.8
	Peel Hunt LLP	19.2	15.1	3.5	116.6		24.5
	Consensus	19.8	15.8	3.4	115.3	20.0	24.8

Profit EPS Dividend Turnover EBIT EBITDA Target price



To own this share, it is important to have a long-term view. I do not see it as one to get rich quick on.

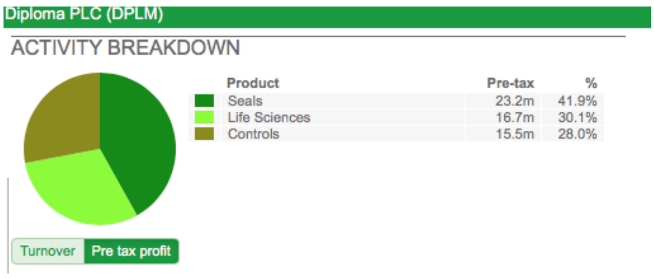
Share Discussion: Diploma (LSE:DPLM)

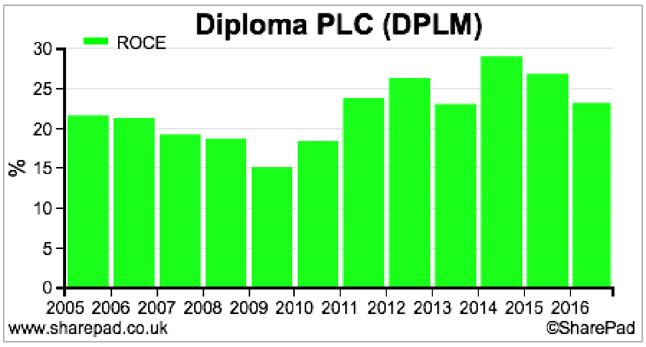
Diploma is a good example of a high-end, niche manufacturer of products for industrial end markets. In order to survive and prosper it has become a provider of solutions for its customers' businesses rather than a supplier of commoditised products. The company's products are mainly focused on its customers day-to-day operating costs which give it a regular and predictable source of revenues and profits.

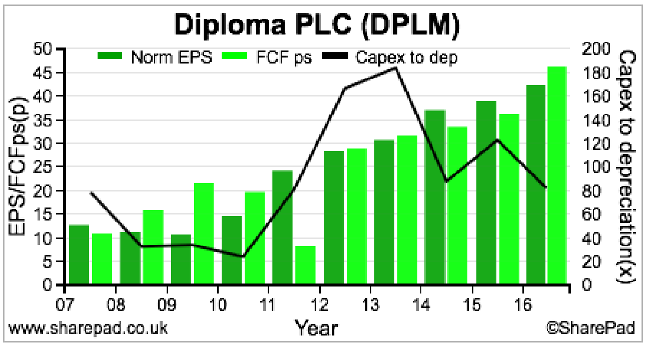
The company is split into three separate divisions:

- **Life Sciences** - sells medical devices to Healthcare sector and environmental analysers, and emissions control products to environmental businesses.
- **Seals** - specialised seals used in mobile machinery and industrial equipment.
- **Controls** - specialised wiring, connectors, fasteners and control devices. These are used in technically demanding applications in sectors such as Aerospace, Energy and Food & Beverages.

This company ticks a lot of boxes for me as a potential investment. It has a good track record of growing its profits through a combination of organic growth. On top of that it has high profit margins, consistently high returns on capital employed (ROCE) and is very good at turning its profits into free cash flow.







Unsurprisingly, its shares have performed well over the last couple of the years and command a high valuation of 23 times forecast earnings.

However, Diploma is also a great example of a high quality business where the fall in the value of the pound since last summer has turbo-charged sales and profits growth as 75% of its sales are made outside the UK. Yet, underlying growth isn't actually that stellar.

My concern with these companies - and there are lots of them on the stock market - is that investors are potentially ignoring the favourable impact of currencies and mistaking it for genuine high growth. When the currency effects wear off - as they are likely to during the second half of 2016 - investors may wake up to the fact that they are owning highly valued shares which are growing only modestly at best.

Diploma's half year results this week are a good example of this. Whilst sales and profits both grew by 21%, underlying growth was 6% which is still respectable.

A closer look at Diploma's divisional results shows these currency effects more starkly.

Life Sciences is facing up to a tough trading environment caused by budgetary pressures in the Australian and Canadian healthcare market. Growth elsewhere has kept underlying growth positive. Going forward, this division will get a boost from the acquisition of Abacus in April this year which gives it opportunities in Australian and New Zealand healthcare markets.

Life Sciences (£m)	H1 17	H1 16	%chg	Underlying %chg
Turnover	£57.9m	£52.5m	10.3%	2%
Operating profit	£10.3m	£9.3m	10.8%	
Margin	17.8%	17.7%		
Seals (£m)				
Revenue	£94.8m	£79.2m	19.7%	2%
Operating profit	£15.4m	£13.4m	14.9%	
margin	16.2%	16.9%		
Controls (£m)				
Revenue	£64.6m	£47.4m	36.3%	16%
Operating profit	£11.7m	£8.1m	44.4%	
margin	18.1%	17.1%		

The Seals division has had a big boost from currency but there has been some margin pressure due to higher currency-related expenses and investment in sales and marketing. underlying revenue growth is weak as the oil and gas sector recovery from its well publicised slump is not particularly strong.

TIDM	Market Cap. (m)	Close	fc PE	fc Yield	TTM EV/EBITDA	Lease-adj EBIT yield
DPLM	£1235.4	£10.91	23.4	2.0	16.5	5.2

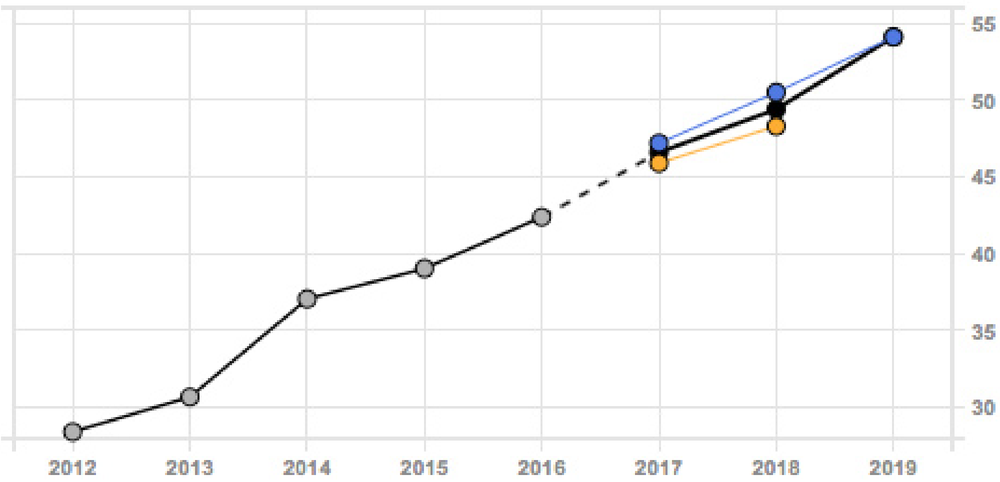
Controls has performed very well, but the company has been very honest about the previous year's comparative being quite weak making growth easier to achieve. There has also been a benefit from new projects coming on stream and acquisitions made in previous years which helped to boost margins in this division.

Diploma has given a reasonably positive outlook statement which indicates that it expects growth to continue. Analysts expect mid to high single digit EPS growth in 2018 and 2019 which is reasonable but not enough for the shares to rerate in my view. Arguably the shares are quite expensive but so are lots of companies with this kind of growth profile at the moment.

← Prev Forecasts for year 2017 Next →

Key	Name	Profit	EPS	Dividend	Turnover	EBIT	EBITDA
Blue	Numis Securities ...	74.5	47.2	22.0	439.4	65.7	80.1
Orange	Peel Hunt LLP	72.0	45.9	21.8	424.3		75.8
Black	Consensus	73.4	46.6	21.9	432.3	65.7	78.1

Profit EPS Dividend Turnover EBIT EBITDA Target price



However, I do expect the company to make further acquisitions as they are a key part of its strategy. With net cash on the balance sheet of £14.8m at the end of March 2017, the company has plenty of financial firepower to buy companies.

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