SharePad's **Phil Oakley** explains how to spot value traps and finds some cheap shares that might bounce back

HOW TO AVOID VALUE TRAPS

Investors are often advised to follow a 'value investing' strategy. Buy value shares because they deliver better returns over time than growth shares. I've always found this mantra somewhat strange; we are all trying to buy shares for less than they are worth. However, when it comes to being a successful value investor it seems that some people struggle to tell the difference between value and cheap. They rarely equate to the same thing.

Certainly, overpaying for a share leads to disappointing returns, but buying a share just because it has a cheap valuation is no guarantee of future riches. In fact, cheap shares are no different to cheap bottles of wine or cheap cuts of meat. More often than not, the reason they are cheap is because they deserve to be. You are not getting a bargain, you are actually paying a fair price.

Many cheap shares are what are commonly known as 'value traps'. Their cheapness is a reflection of their inferior quality in some way. This is why investors who buy them rarely make any money out of them. They are not buying them for less than they are worth.

The other thing to bear in mind is that the stock market is not stupid. It can be irrational from time to time, but shares are rarely given away cheaply without good reason – except perhaps in times of market crashes. However, that does not mean it is impossible to bag yourself a bargain.

This article is all about how you can avoid value traps and how you can identify shares that might have been overlooked. We will examine the things to look out for by using real cases from the UK stock market. Let's look at some examples of value traps first.

Trinity Mirror – a business in structural decline with big liabilities

If you are screening the FTSE All-Share index looking for cheap shares, then **Trinity Mirror (TNI)** looks one of the cheapest out there, trading on just over three times forecast earnings.

How can this business be so cheap? Surely it is the wrong price? It might be significantly undervalued, but the shares have looked cheap for years and have proved to be a very disappointing investment.

1. Trinity Mirror share price

The main reason for this is that its print newspaper titles have been experiencing a significant decline in circulation and revenues. The way people read news has been shifting away from printed products to the internet and mobile applications.

Fewer people reading the *Daily Mirror*, *Daily Record* and hundreds of local newspapers has not only seen circulation volumes and revenues fall – despite cover price increases – but advertisers have taken their business elsewhere as well.

Trinity Mirror has tried to meet these revenue falls by cutting costs. The trouble with this strategy is that the ability to cut costs eventually runs out. What is needed to stop the rot is another source of revenue growth. The company is growing its digital revenues, but not fast enough to offset the continuing decline from the print business. Consequently, the company has falling revenues and underlying profits when the cost-cutting runs out.

By focusing on a low price-earnings (PE) ratio, investors are ignoring the company's massive pension fund deficit. At £466m it dwarfs the current market capitalisation of £295m. The fund has been closed to the further accrual of member benefits since 2010, and so there is little cost expensed for it in the income statement.

However, £40m of cash was paid into the fund in 2016 in an attempt to plug the deficit. This has led to Trinity Mirror's free cash flow being significantly lower than its earnings for several years – and the amount of free cash flow has been shrinking.

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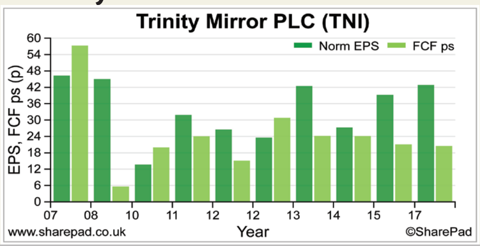
2. Trinity Mirror EPS & FCF



The shares arguably look cheap on around four times historic free cash flow – which takes into account the cash paid into the pension fund – but how do investors accurately price a business that is declining rapidly with a giant millstone around its neck? The truth is that they can't and this is why the shares have stayed cheap and may continue to do so.

Carillion – growth by acquisition runs out, unsustainable dividend

3. Carillion share price

You should always be wary of companies that tend to grow by buying other companies. This is because acquisitions can mask growth problems in a company's underlying business. Profits might seem to be growing when they aren't really.

Carillion spent heavily on three big acquisitions during the past decade as shown in the table below.

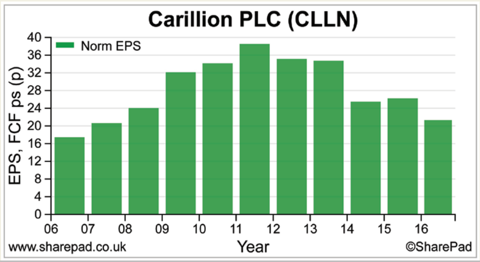
Carillion's acquisitions

Year	Company	Cost (£m)	Cash paid (£m)	New shares (£m)	Other
2006	Mowlem	350.3	117.3	224.5	8.5
2008	A McAlpine	554.5	171.7	381.5	1.3
2011	Eaga	298.4	180.7	117.5	0.2
Cumulative		1,203.2	469.7	723.5	10

These acquisitions allowed the company to make significant cost savings by integrating them into existing company structures and contributed to significant growth in profits and dividends at the time.

What is interesting with all three acquisitions is that when the cost-saving projects came to an end after a couple of years, **Carillion (CLLN)** then made – or tried to make – another acquisition. This process came unstuck in 2014 when Carillion failed to merge with Balfour Beatty.

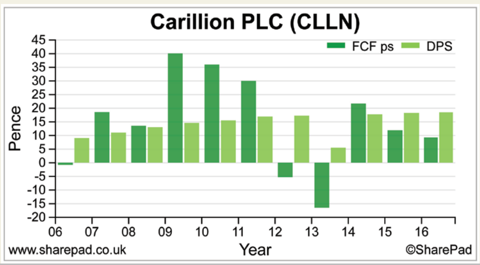
4. Carillion EPS



You can be forgiven for thinking that the company might have become too reliant on buying other companies – and the cost savings that come with it – in order to grow. Is it a coincidence that since 2014 the company's profits growth and share price performance have not been too stellar?

Investors may be attracted to Carillion because of its 9 per cent dividend yield. However, this looks unsustainable given the company's weak free cash-flow performance.

5. Carillion FCF & DPS



Carillion has been somewhat reliant on selling stakes in PFI companies to generate the cash needed to pay its dividend. This source of cash is almost exhausted, while the company also has a big pension deficit to plug. It would not be surprising if Carillion's dividend suffered a substantial cut.

Dunelm – growth ground to a halt, shares still relatively expensive

6. Dunelm share price

Up until last summer, homewares company **Dunelm (DNLM)** was a popular share with investors. They were highly rated and traded on a valuation of more than 20 times earnings.

With trading turning down in the autumn, the ▶

'Overpaying for a share leads to disappointing returns, but buying a share just because it has a cheap valuation is no guarantee of future riches'

▶ shares have slumped and the valuation looks more attractive at 14 times forecast earnings. That might lead some investors to think that the shares are cheap and a bargain purchase at current levels.

But are they really? One big reason why they might not be is that the company's previous source of growth – opening new stores (known as a 'retail rollout') – has played itself out.

During the first few years of a retail rollout everything can seem fine. The profits keep growing and underlying performance of the existing business seems to be good as measured by things such as like-for-like sales growth. Investors believe that they are owning a quality growth stock.

Then things can change:

1. The business matures and begins to reach an optimal size. The effect of opening new stores on the business as a whole starts to reduce and growth rates shrink.
2. Competition enters the market to grab a share of the high returns being made. This pushes down prices, profits and returns on capital employed (ROCE) for all companies.
3. The company overexpands and starts cannibalising its own business. For example, a new shop is opened too close to one of the company's existing shops and takes sales from it. This reduces the profits of both the new store and the existing one.
4. The company struggles to match the lofty profit expectations of analysts and investors. It warns on profits, the shares collapse and the valuations attached to the shares fall (read a lower PE ratio).
5. Investors lose money.

This sums up what has happened to Dunelm. However, despite the shares being cheaper than they were a year ago, they are still quite expensive compared with other retailers. The decline in Dunelm's PE ratio could have further to go.

The need for a catalyst

Shares can stay cheap for long periods of time. In order for a cheap share to become more expensive so that investors can make money from them, something needs to change. This change is known as a catalyst – an event that gets investors to take a more positive view on the company, which pushes up the price of its shares.

Catalysts can take many forms such as:

- A takeover of a similar company for a much higher valuation.
- An upturn in trading performance.
- The removal of a negative influence, such as litigation, debts, an underperforming business or accounting scandal.
- Continued solid performance that eventually gets noticed.

It is very common for professional analysts and investors to extrapolate a company's current performance into the future. So a good company will stay good and vice versa. You tend to get big share price movements when those expectations change with a catalyst.

In the box on the right I've highlighted some relatively cheap shares that might have the potential to bounce back in the months ahead.

Cheap shares with the potential to bounce back

BT – accounting scandal is forgotten, significant free cash flow and growing dividends

7. BT share price

BT (BT.A)'s shares fell by 20 per cent in January when it announced the discovery of some dodgy accounting at its Italian subsidiary. This blackened an already dark cloud that was hovering over the company. There has been considerable uncertainty over its ownership of the Openreach telecoms network, its large pension fund deficit and its hold on Champions League broadcasting rights.

The accounting issue will quickly wash out, while BT still has significant free cash flow to fund 10 per cent dividend growth and plug the hole in its pension fund. It has managed to retain its Champions League rights without paying more than analysts expected. On just over 11 times earnings with a 4.6 per cent prospective yield, the shares could gradually recover.

Next – are investors too pessimistic?

8. Next share price

Next (NXT)'s shares have been hammered as it has admitted that profit growth will be hard to come by over the next year or so. Unlike Dunelm, which trades on 14 times forecast earnings, Next's forward PE ratio is only nine times. Despite its difficulties, the company remains very cash generative, well financed and continues to generate outstanding ROCE. It has an established internet retailing operation that is better placed than many of its rivals to cope with the changing retailing landscape.

It is using its impressive free cash flow to pay big dividends to shareholders. Investors are being paid to wait for an upturn in its trading performance. It is also possible that its low valuation could attract a takeover bid. This is a share that is so lowly valued that a positive catalyst could see a big rise in its price.

Greene King – quality assets and dividend growth

9. Greene King share price

Greene King (GNK)'s shares were hammered after the EU referendum as investors fretted about how the impact of leaving the EU might affect the pub sector. The shares are still trading lower as people continue to worry about its prospects.

Yet Greene King's trading performance appears to have held up well, with like-for-like sales growing. It has some quality pub assets in the affluent south-east of England that remain well placed to exploit the trend in eating out.

The company is also managing its property assets well. Selling pubs is a regular part of its business and this is bringing in some decent cash proceeds, which means that Greene King will keep on increasing its dividend.

With the UK economy continuing to defy the doom-mongers, Greene King's shares trade on just over nine times earnings and a yield of nearly 5 per cent could push higher in the months ahead.

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