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Diploma makes products for medical, industrial and aviation purposes



# What's Diploma worth?

Value is an intrinsic component of deciding which companies make it to the Thrifty 30. Richard Beddard outlines how he measures it

One of my ambitions for the Thrifty 30 portfolio is to insist on value, without being too dogmatic about where it comes from. Some value investors buy shares they reckon cost less than the book value of a

company (assets less liabilities). Others buy shares in businesses they reckon will earn a lot more in the future.

Those businesses destined to earn their shareholders large profits in the future may be worth more than their book values now, but establishing how much more is difficult. The future is, of course, quite unpredictable.

There are signs, though, that can show when a company has a good chance of growing its profits. Chief among them are profitability ratios and the return on equity. A company with a consistent record of relatively high profitability is probably well managed and an engine for future growth. That's because its profits give it money to invest, and investing the money in the business earns high returns.

Diploma looks like one of those companies. It's earned close to 15 per cent on equity for most of the past decade, ever since it was reorganised into three divisions supplying blood-testing instruments, seals for hydraulic cylinders, and controls used in aircraft.

**It looks like a superior business that** will continue to earn high returns, even though big profits should, in theory, invite competition. It's performed well in the recession, because most of its sales come from consumables, such as the seals used to repair fork-lift trucks. Its products are specialised, so it isn't easy for customers to switch. The average tenure of Diploma's 60 senior managers is 10 years, and over the decade it's been acquiring closely related companies to strengthen its position in its market niches.

There is nothing wrong with Diploma, as far as I can see, except its price. At 2.5 times book value and 27 times average 10-year earnings, it's way more than my usual maximum of 20.

But instead of putting its annual reports in the bin, I did what all weak and craven value investors do when they want to buy shares in a company but think the shares may be too costly. I tried to find a different way of valuing it. A way that makes it look cheap.

I made two forecasts to incorporate future profit in today's valuation. One presupposed the company will continue at its current level of profitability for six years and then decline. The other that profitability would increase for 10 years, and then stagnate. The first suggests Diploma is very expensive and the second that it is a bargain.

Who knows which is right? The future is uncertain. But while some companies remain competitive for decades; most succumb to competitive pressure sooner. The odds are against Diploma, and if I'm to remain true to my value principles, I won't add the shares to the Thrifty 30 unless they are clearly cheap.

**Richard Beddard** is companies and markets editor of our sister website *Interactive Investor*. You can follow changes to the Thrifty 30 portfolio and commentary at <http://blog.iii.co.uk>

## THRIFTY 30 CONTINUES TO MOVE AHEAD



## HOW THE CONSTITUENTS STACK UP

Name	Shares	Price (£)	Cost (£)	Value (£)	Return %
Alumasc	938	1.56	999	1,459	46
Armour	21,278	0.06	2,250	1,330	-41
AutoLogic Holdings	3,517	0.21	1,000	739	-26
Castings	515	2.78	999	1,429	43
Clarke (T)	706	1.00	1,000	708	-29
Dart	1,824	0.85	1,000	1,546	55
Dewhurst	735	3.78	2,244	2,775	24
French Connection	2,310	1.11	1,000	2,564	156
Games Workshop	348	3.70	998	1,288	29
Haynes Publishing	539	2.56	999	1,380	38
Holders Technology	1,437	1.17	999	1,674	68
International Greetings	1,696	0.73	1,097	1,238	13
Johnson Service	5,035	0.33	1,000	1,674	67
Mallett	1,591	0.73	1,000	1,153	15
Northamber	2,276	0.61	1,200	1,388	16
Northgate	511	3.21	1,099	1,639	49
Printing.com	2,940	0.37	1,000	1,073	7
Quadnetics	643	1.86	999	1,193	19
Ricardo	386	3.50	999	1,351	35
Solid State	1,950	0.95	1,000	1,843	84
Thorpe (F W)	166	7.80	1,193	1,295	9
Titon Holdings	2,493	0.53	1,000	1,309	31
Trifast	3,112	0.46	1,130	1,416	25
Waterman	2,431	0.42	1,000	1,021	2
Total current holdings			27,202	34,483	27
Cash				4,947	
<b>Total portfolio</b>			<b>30,000</b>	<b>39,430</b>	<b>31</b>

Notes: £10 broker fee charged for all transactions, and 0.5 per cent stamp duty for purchases. Cash earns no interest. Dividends and sale proceeds are credited to the cash balance. £30,000 invested on 9 September 2009 was worth £39,430 on 1 April 2011. £30,000 invested in a FTSE All-Share ETF was worth £37,939 (dividends reinvested). Objective: To beat a FTSE All-Share ETF handsomely over any five-year period. Source: ShareScope, 1 April 2011

## FOR MORE ON THE VALUATION TECHNIQUES USED:

<http://blog.iii.co.uk/category/ivp/>  
 Although I investigated Leeds Group and Diploma this month, I made no changes to the Thrifty 30. <http://blog.iii.co.uk/tag/ldsg/> and <http://blog.iii.co.uk/tag/dplm/>