



Sinners 2020

Accounting red flags for UK stocks

September 2020

“There is no sinner like a young saint.” Aphra Behn

A bit like the football season, the launch of the 2020/21 ‘Sinners’ vintage – our red flag accounting and governance model for UK stocks – has been a little delayed by the pandemic. We can point to slower reporting - Annual Report & Accounts are the critical input and many were lagged. But focusing on bottom-up work in a period when many end markets have been thumped 9-0 - the median FTSE stock is still down 21% since March - is a priority at turning points. Quant models, particularly those, like Sinners, based on unearthing slow-moving trends to imply a degree of ‘fudging’, are not as strong when faced with massive changes in assumptions.

But one benefit is that we have an extra set of year-ends to include – quite a nerdily exciting prospect for me, given for the past 7 years the analysis has been done in May, when the highest proportion of companies – the December year-ends – will have just put out their R&A. This year, we get fresh data for the March and the Junes.

What are we trying to achieve with Sinners? The primary use is to draw our attention to areas of management judgement, short-term decision making and hidden risks within a business and its accounts. It’s important to be aware of potential flags when weighing up new and existing Long ideas, and it can be a particularly fertile ground to hunt for Shorts – the companies that screen will have little margin for error in their numbers.

Bear in mind, though, that some flags will be perfectly explainable – a change in business model or even a pandemic leading to abnormal exceptionals. But we do find year in year out, that a broad basket made up of ‘Sinner’ stocks – that exhibit the patterns of aggressive management – underperforms the market¹. This is even after diversifying across factors – crucial for this stage in the cycle when poor performing, indebted, low multiple companies can rally sharply regardless of underlying business health.

Figure 1: Sinners 2020/21 – ‘Top’ 10

Name (* = NEW)	Sector	Mkt Cap (£m)	Beta (250)	P/E ratio (+24m)	Rel Perf -12m	Rel Perf Y/E	30d avg. (£m)	Year end (FY)	Profit Smoothing (33.0% wt)	Biz risk & Governance (25.0% wt)	Cash & capital (19.5% wt)	Ditress models (21.5% wt)	Overall Score
Capita	Support Services	489	1.68	2.9	-62.4	-61.9	3.0	Dec '20	1.63	0.42	0.75	1.08	3.88
Aston Martin Lagonda	Autos	959	1.25	n.a.	-53.6	-48.2	5.7	Dec '20	1.25	0.71	1.03	0.44	3.43
National Express Group*	Support Services	895	1.81	5.1	-49.0	-48.7	6.0	Dec '20	1.09	1.45	0.41	0.37	3.32
GVC Holdings	Tech & Platforms	5,747	1.46	11.5	49.8	31.4	18.4	Dec '20	0.91	0.76	0.35	1.16	3.19
Just Eat Takeaway.co*	Disc. Retail	12,922	0.50	51.2	n.a.	n.a.	8.3	Dec '20	0.72	0.50	0.87	1.09	3.18
International Consolidated	Leisure	1,954	1.67	4.2	-52.0	-57.0	28.3	Dec '20	0.78	0.91	0.93	0.45	3.07
Standard Life Aberdeen*	Diversified Fins	4,886	1.39	12.6	2.3	-5.8	12.2	Dec '20	0.39	1.20	0.48	0.97	3.04
Energiean*	Oil & Gas	1,093	1.30	6.7	-16.7	-13.3	1.1	Dec '20	0.73	1.02	0.85	0.42	3.02
Redrow	Housebuilding	1,408	1.37	5.9	-18.0	-4.6	4.9	Jun '21	0.00	1.06	0.85	1.02	2.92
Ascential*	Media	1,224	0.96	17.4	-2.4	-2.2	1.5	Dec '20	1.80	0.20	0.86	0.00	2.86

Source: Tellworth Investments, Bloomberg, Company Reports

¹ Performance of the UBSRED and MLEIRED1 Sinners baskets underperformed the FTSE All-Share 6% and 10% in 2018/19 and 2019/20 respectively, for prior vintages we draw on Sebastian Jory’s Sinners publications at Liberum

This year we have added 2 new screens to the stable and removed 1, meaning the Sinners score is a compound of 20 different flags – see Figure 2 for the full list. *Auditor Cost as a Proportion of EBIT* is an interesting proxy for the complexity of a company’s accounts, and by proxy its business model. We also add *Soft-asset Acquisition*, as consistent large consolidation of goodwill and intangibles is associated in studies with a higher likelihood of accounting misstatements². We remove the *IFRS 16 leases* screen, as most companies now report on this basis.

Our flags are grouped into four roughly equally weighted categories – *Profit Smoothing*, *Business Risk & Governance*, *Cash & Capital* and *Distress Models*. Picking on the company that screens worst this year, *Capita* – which has been a regular fixture since we began running the model in 2013 – we find a litany of flags from *Profit Smoothing* (consistent use of exceptionals, increasing time to collect, heavy use of deferred revenues) to *Business Risk* (audit cost, payables crunch) and finally unsurprisingly high (bad) scores on our *Distress Models*.

Above we show this year’s top 10 Sinners, leaving the rest to the reader’s guesswork. We would be happy to go through the models, scoring and Sinner stocks in further detail with clients – accounting might not be the hottest of topics at the moment, but it still really helps in separating a good cheap company from the biggest sin of all: a value trap.

Figure 2: Components of Sinners

	Profit Smoothing						Biz risk & Governance							Cash & Capital				Distress Models		
	Excep-tionals	Rec Days	Bad Debtors	AROC	LT R Days	Def Revs	Gover-nance	CEO Tenure	Audit Cost	Chg. Emps	Inv Days	Pay: Extend	Pay: Crunch	FCF Flattery	Cash Conv	Stock Comp	Debt 4 Divis	Soft Acq.	Alt-Z (Default)	M-Score (Manip)
Wt:	4.0	5.0	1.5	2.0	1.5	1.5	2.5	4.0	2.0	1.5	2.5	1.5	2.0	1.0	5.0	3.0	2.0	3.0	2.5	6.0

Source: Tellworth Investments

Seb Jory co-manages our TM Tellworth UK Select Fund, a large cap UK absolute return UCITS strategy that has delivered +10.23 % YTD (vs the FTSE All Share -18.54%) Returns quoted are net of fees on the F share class as of 31/08/2020. Source: FE Analytics, Bloomberg.

² "Predicting material accounting misstatements" - Dechow, Larson, Sloan (2010)

Disclaimer

Tellworth Investments LLP (“Tellworth”) is an appointed representative of BennBridge Ltd (“BennBridge”), based at Eagle House, 108-110 Jermyn Street, London SW1Y 6EE. BennBridge is a limited company registered in England with registered number 10480050. The registered office is Windsor House, Station Court, Station Road, Great Shelford, Cambridge CB22 5NE. BennBridge is authorised and regulated by the Financial Conduct Authority (FRN: 769109). The investment manager to the TM Tellworth UK Select Fund is BennBridge Ltd and the authorised corporate director is Thesis Unit Trust Management. The Fund is authorised in the United Kingdom and regulated by the Financial Conduct Authority. Please see the prospectus and key investor information document for full details.

Any projections, market outlooks or estimates contained in this letter constitute forward looking statements, and are based on certain assumptions and subject to certain known and unknown risks. Accordingly, such forward looking statements should not be relied upon as being indicative of future performance or events. Past performance is not indicative of future results. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

In the United Kingdom, this document is only available to persons who are (i) investment professionals within the meaning of Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (“FP Order”), (ii) high net worth companies and certain other entities falling within Article 49 of the FP Order; or (iii) to any other persons to whom such communications may lawfully be made. It must not be acted, or relied, upon by any other persons.

This document may not be reproduced or distributed by the recipient, in whole or part, except that this document may be provided to the recipient’s advisers in connection with an evaluation of a potential investment.

This document is being provided by BennBridge for informational purposes only and should not be construed as investment advice. It is not a recommendation of, or an offer to sell or solicitation of an offer to buy, any particular security, strategy or investment product. BennBridge’s research for this presentation is based on current public information that BennBridge considers reliable, but BennBridge does not represent that the research or the presentation is accurate or complete and it should not be relied on as such. The views and opinions contained herein are those of Sebastian Jory and John Warren, Fund Managers. They do not necessarily represent views expressed or reflected in other BennBridge investment communications or strategies and are subject to change.

Risk Factors

The counterparty to a derivative or other contractual agreement or synthetic financial product could become unable to honour its commitments to the fund, potentially creating a partial or total loss for the fund. The fund can be exposed to different currencies. Changes in foreign exchange rates could create losses. A derivative may not perform as expected, and may create losses greater than the cost of the derivative. If a fund uses derivatives for leverage, it makes it more sensitive to certain market or interest rate movements and may cause above-average volatility and risk of loss.

Equity prices fluctuate daily, based on many factors including general, economic, industry or company news. In difficult market conditions, the fund may not be able to sell a security for full value or at all. This could affect performance and could cause the fund to defer or suspend redemptions of its shares. The fund may take positions that seek to profit if the price of a security falls. A large rise in price of the security may cause large losses.

Failures at service providers could lead to disruptions of fund operations or losses.

CONFIDENTIAL – NOT FOR DISTRIBUTION