Buying: Senior PLC (SNR)

Improve the portfolio : *As companies grow (or shrink) and as their share prices go up (or down) the attractiveness of the investment changes. If a company's share price shoots up quickly its shares may no longer represent good value for money, while a company that falls into a long-term decline may no longer be remotely defensive. In both situations selling can be the right course of action.*

Price on 1st June 2016	Index	Sector
217p	FTSE 250	Aerospace & Defense
FTSE Market Cap	**Revenue**	**Normalised Post-tax Profit**
£911 million	£850 million	£71 million

"Senior is an international, market-leading, engineering solutions provider. Senior designs, manufactures and markets high-technology components and systems for the principal original equipment producers in the worldwide aerospace, defence, land vehicle and energy markets." (www.seniorplc.com)

Overview

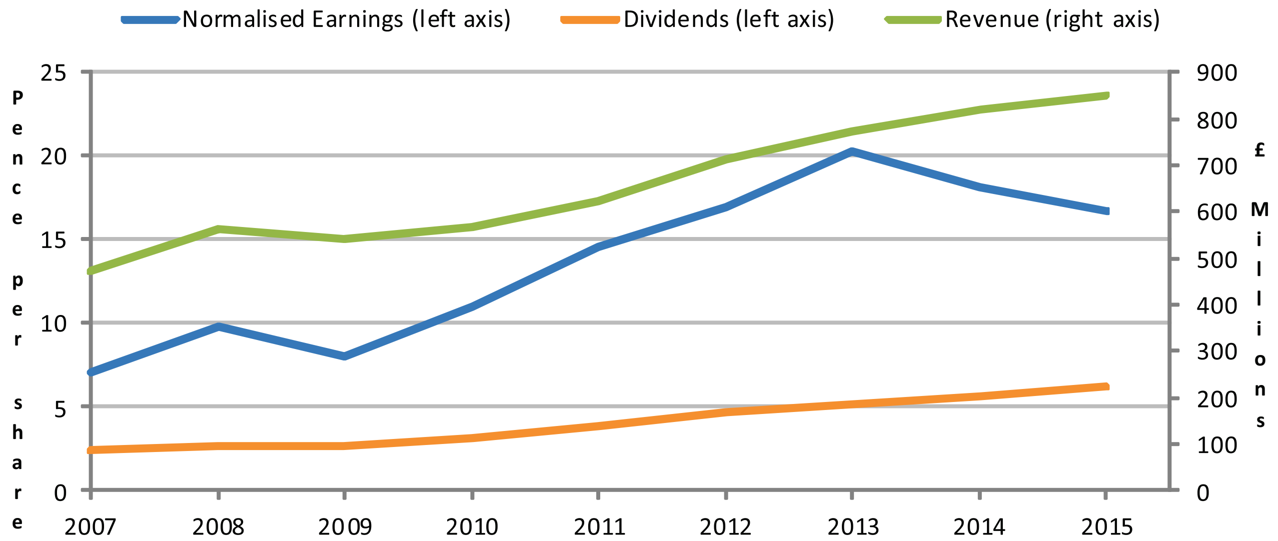
Senior was founded in 1933 as Senior Economisers when a few employees of Green's Economisers set up in competition against their old company. Given that two of the founding directors were David and Francis Lycett-Green (Francis was the Chairman of Green's Economisers) it looks as if a family falling out may have been the reason for the creation of Senior. Unfortunately I could not uncover any more detail than that.

From the beginning Senior was involved in fuel efficiency through its fuel economiser and although the economiser itself is history, fuel efficiency is still a major part of Senior's business today. Along the way various acquisitions led the company into a wider range of mechanical engineering activities, with the company now operating as a interdependent group of semi-autonomous businesses involved in the design and manufacture of components for the aerospace industry (used in airframes, fluid systems and gas turbine engines) and Flexonics (primarily tubing and ducting for land vehicles and industrial uses).

Senior has a good record of growth which has occurred both organically and through acquisitions. However, in the last couple of years profits have fallen as some of its end markets have slowed.

Growth Rate	Dividend Yield	Profitability	PE10
12.0% (min 2%)	2.9%	11.7% (min 7%)	15.9 (max = 30)
Growth Quality	**Debt Ratio**	**Pension Ratio**	**Rank**
79% (min 50%)	2.9 (max 5)	4.3 (max 10)	36 (out of 240)

Green = Better than FTSE 100; Pink = Worse than FTSE 100; Red = Outside the "rule of thumb" minimum or maximum values



Investment checklist

Successful investing requires the methodical application of a systematic approach in order to achieve specific objectives, and a checklist is a great aid towards that end. This checklist helps to ensure that the company under investigation is high quality and that its shares are likely to improve the portfolio in the long-run.

Maintaining and increasing portfolio diversification

1. Will this purchase leave the portfolio's average UK revenues at less than 50%?

YES Senior generates 18.9% of its revenues from the UK so it will reduce the portfolio's UK exposure.

2. Will this purchase leave the number of holdings from cyclical sectors at 15 or less?

NO Although Senior is from the defensive Aerospace & Defense sector, the portfolio still currently has 16 cyclical holdings. However, the addition of Senior does at least avoid increasing those cyclical holdings further.

3. Will this purchase leave the number of holdings from this company's sector at 3 or less?

YES There are currently two other Aerospace & Defense sector holdings in the portfolio (BAE Systems and Chemring) so Senior will be the third and last for now.

Avoiding value traps

Good management

1. Is the company focused on a clear and consistent goal and strategy?

YES The company has had the same goal and broadly the same strategy for many years.

Goal: Senior's primary performance objective is to create long-term and sustainable growth in shareholder value.

Strategy: The company aims to achieve that goal through the development of a portfolio of collaborative high value-added engineering manufacturing companies operating within its chosen five market sectors. Operations are focused on manufacturing components and systems for original equipment manufacturers (OEMs) and the company's products are typically highly engineered and require advanced manufacturing processes.

The five market sectors consist of three in Aerospace (consisting of 19 subsidiaries and representing 68% of total revenue) - Structures, Fluid Conveyance Systems and Gas Turbine Engines; and two in Flexonics (consisting of 14 subsidiaries and representing 32% of total revenue) - Land Vehicle Emission Control and Industrial Process Control. The company expects each of these market sectors to provide healthy and accessible growth opportunities and various strategic objectives have been developed to exploit them.

2. Does the company have an obvious core business that the strategy is focused on?

YES As described above, Senior's core business is the design and manufacture of advanced and highly engineered components for its five market sectors.

Adequate financial control

3. Do the Key Performance Indicators (KPIs) focus on factors beyond revenue and EPS growth such as profitability, leverage, liquidity and investment?

YES There are KPIs for return on revenue (margin) and capital, both of which are measures of profitability. Profitability is perhaps the most important non-growth factor to measure in my opinion.

Low costs

4. Scale: Is the company in the leading group in terms of market share?

YES Senior describes itself as market-leading as do many of its individual subsidiaries. For example, one of its latest acquisitions, Steico Industries, is the world leader in aerospace tube and duct assemblies.

5. Experience: Has the company had the same core business for many years?

YES Senior has been involved in efficiency technologies since its founding in 1933 and tubing, ducting and high precision engineering components from not long after 1933.

Caution with big projects

6. Is the company free of "bold" projects which could push it into a major crisis?

YES There are no bold bet-the-company projects that I can see.

7. Is the company free of the need for large capital expenditures (capex)?

YES Over the past decade Senior's capex came to 45% of profits. I consider anything below 50% as low, so I would categorise Senior as a low capex company.

8. Are revenues generated by the sale of a large number of small-ticket items rather than major one-off contracts?

NO Although Senior manufactures many thousands of individual components those components are not sold or ordered on an ad-hoc basis. Instead the company signs contracts to supply predefined sets of components to OEMs which are then used to build and maintain end products such as aircraft, cars, oil rigs and all manner of other things.

A good way to reduce risk from large contracts is to not become over-dependent on any one contract or customer. In Senior's case its largest customers are Boeing (12% of revenues) and Rolls-Royce (10%). It's difficult to know exactly what over-dependent is, but personally I think it would need to be more than 12%.

Caution with acquisitions and mergers

9. Has the company avoided mergers or large acquisitions in the last few years?

NO Senior's business model is to operate as a portfolio of companies in order to get the best of both worlds of entrepreneurial autonomy as well as synergistic collaboration (apologies for the buzzwords).

As such it is no surprise that the company has spent an average of 70% of profits on acquisitions over the past decade and has spent more than 100% of profits on acquisitions in 2009, 2011 and 2015. The largest acquisitions were:

2009: Capo Industries (£44m) - Capo Industries specialises in the machining of titanium and steel alloys primarily for auxiliary power units on large commercial aircraft and for propulsion engines on business jets.

2011: Damar Machine (£15.8m) - Damar is principally a manufacturer and integrator of precision machined parts and assemblies for the commercial aerospace industry; Weston EU Limited (£53.0m) - Weston has a well established reputation in the aerospace industry, specialising in the machining and assembly of aerofoils, aluminium and hard metal structural parts and premium aircraft-seat structures.

2015: Lymington Precision Engineering (£45.8m) - Manufactures precision-machined components, fabrications, assemblies and kit sets for the oil and gas, telecommunications, aerospace, defence, land and sea systems, nuclear and marine industries; Steico Industries (£50.2m) - A leading manufacturer of precision tube and duct assemblies for the commercial and defence aerospace industries.

10. Has the company avoided large acquisitions that have little to do with its core business?

YES All of the company's large acquisitions were very closely related to its core businesses.

Ability to adapt to changing market demand

11. Does the company operate primarily in defensive markets?

NO Although the Aerospace & Defense sector is defined as defensive in the Capita Dividend Monitor, I think Senior is primarily exposed to cyclical markets. For example, the company's revenues are generated 55% from the commercial aerospace industry (cyclical), 15% from military aerospace (defensive), 15% from land vehicles (cyclical) and 15% from petrochemical, power and other industrial uses (mostly cyclical).

Having said that, Senior operates in a wide variety of end markets, most of which have different cycles from one another. That diversity of market cycles is likely, in my opinion, to reduce their aggregate cyclicality in much the same way as a diverse portfolio of stocks can reduce volatility. Also, Senior supplies components for both newly built end products (e.g. engines) and their maintenance, and maintaining those products is, generally speaking, a more defensive activity. For example, in a recession Boeing may build less aircraft, but the engines of existing aircraft still have to be serviced (although perhaps slightly less frequently).

12. Does the company operate in markets where the pattern of demand (whether cyclical or defensive) is unlikely to be disrupted in the short or medium-term?

YES Having spent a couple of days reviewing Senior I haven't found any significant evidence of impending disruption to the pattern of demand for components in its key markets.

13. Does the company operate in markets where demand is expected to grow?

YES The company operates in a range of markets and the growth prospects for each of them is as follows:

Commercial aircraft: Annual growth in global passenger air traffic is forecast to continue and is the key driver of demand for new commercial aircraft, and hence for many of Senior's core aerospace products. Senior has also secured significantly higher content on several new engine versions of leading aircraft than the current versions, allowing the company to outgrow the market as these new engine versions come into service and production ramps up.

Military aerospace : Senior's revenue from this sector is expected to benefit from several new military aircraft where production is scheduled to ramp-up significantly between now and the end of the decade. Also, European and US defence budgets are starting to rise following increased geopolitical tensions.

Land vehicles: Demand for the majority of Senior's products in the land vehicles market is linked to the increasingly stringent global requirements for reduced carbon emissions. This arises in the form of reduction targets for emissions from vehicles and increased fuel efficiency from their engines.

Industrial: Senior designs and manufactures products for petrochemical, HVAC (heating, ventilation, air conditioning) and power and energy markets, to meet an increasingly stringent regulatory environment. Over the longer term, projected increases in global energy usage, tightening emission control regulations and emerging changes in power generation should drive increased global demand for Senior's industrial products.

Competitive product, service and price

14. Does the company generate most of its profits from products or contracts that do not need to be replaced in the next 10 years?

NO My expectation is that most of Senior's products will need to be replaced within the next ten years, in line with the replacement and improvements of its customers' end products. I don't see this as particularly problematic though, partly because the company doesn't depend on any one product to any meaningful extent, but also because improving and redesigning components and products is one of Senior's core competencies.

15. Does the company sell differentiated products that do not compete purely on price?

YES Senior's products are often critical components in a larger system. The benefits of saving a few pence on a given component will often be outweighed by the risk of those components failing, or not performing to standard. I would say that reliability and performance, rather than price, are of primary importance.

Indifferent to commodity prices

16. Is the company relatively immune to commodity price movements?

YES Although Senior's products are usually made out of commodity materials, I don't think the company's results are primarily driven by commodity price cycles.

Sound financial policy

17. Does the company have a target rate of return on investment of more than 10%?

YES The company has a target of producing a pre-tax return on capital employed of more than 15%.

18. Is the company's use of leverage conservative enough given the preceding answers?

YES The company's debt ratio is 2.9 and I don't see any obvious reason why that would be too high.

19. Are the chances of this company becoming a value trap acceptably low (and if so, why are the shares attractively priced)?

YES Having looked at Senior's latest annual results and other statements, I don't think the company is having any sort of crisis at the moment and there is no obvious reason to expect a dividend cut or worse. As such I don't think Senior is likely to be a value trap, at least in the medium-term. So if Senior isn't in serious trouble, why is it ranked highly on the stock screen?

The first thing to say is that Senior doesn't have an extremely high ranking. Its rank is 36, which is somewhat low for a new purchase. The reason I have selected Senior rather than a higher ranked company is that the model portfolio needs a defensive sector stock, and Senior is the highest ranked defensive sector stock which is suitable.

In terms of valuation, I don't think Senior is obviously cheap. It has a 2.9% dividend yield and a PE ratio of 13 and neither of those would be particularly attractive for most companies. However, Senior is not most companies. It has a very good track record of fairly consistent double digit growth, extremely good dividend cover, a strong balance sheet and what appear to be good prospects for future growth. Put another way; most companies with a history of double digit growth and the potential for continued double digit growth do not have near-3% dividend yields.

In terms of why the shares might be cheap (although not obviously cheap), I would say the primary reason is the company's Flexonics division. While the aerospace division continues to grow organically, the Flexonics division is having a hard time at present. Sales of North American heavy-duty diesel trucks, many of which use Senior components, is slow and is expected to continue to slow further, while the off-highway vehicle market is also slow, partly due to the current low-point in the commodity and oil markets. Both of these are expected to be cyclical phenomenon and in the longer-term Flexonics markets are expected to continue to grow.

Overall then, I see Senior as a good growth company which is currently facing some cyclical headwinds that are expected to dissipate in the medium-term.

Uncovering competitive advantages

1. Does the company have any intangible asset advantages (brand names, patents, regulatory barriers)?

NO Senior does have a good reputation and a good brand name which would definitely help it to win contracts, but I'm not sure they're enough to be considered an intangible asset advantage.

2. Does the company gain an advantage from "switching costs", i.e. the effort required for customers to switch to a competitor?

YES In my opinion the time, money and risk costs of a customer switching from Senior to one of its competitors are large enough to be called a switching cost advantage. That's because supply chains often involve far more than simple transactional relationships between suppliers and customers. This is especially true when the supplied products are difficult to manufacture and are required regularly and in large numbers. The benefit to an OEM such as Boeing from switching to a new supplier who promises to supply key components for a slightly lower price than Senior can easily be offset by any problems that arise. It is far easier and less risky to stick with a known supplier who has a proven track record with that OEM.

3. Do the company's products or services have a "network effect", i.e. become better as more people use them (e.g. Facebook, eBay)?

NO Senior's products do not become better as more of them are sold.

4. Does the company have any durable cost advantages (e.g. unique location, unique low cost source of raw materials, greater scale)?

NO Senior is in the process of lower its cost base but I don't think it has a durable cost advantage.

Making the trade - Are you happy to own these shares for at least 5 years?

YES I think Senior is a high quality growth company which is currently facing some relatively minor and probably short- or medium-term headwinds in its Flexonics division. The company operates primarily in markets that it expects to grow by around 4% per year, and in addition it expects to outgrow those markets in the future as it has done in the past.

I am comfortable with the idea of holding shares in Senior for at least five years (although in reality the investment could cover a much longer or shorter period) and so I will be adding Senior to both the model portfolio and my personal portfolio a few days after this issue is published.

Higher ranked stocks that were not selected	Reason for not selecting
Amec Foster Wheeler, Jardine Lloyd Thompson	Debts too high
Victrex, Stagecoach, Ashmore, Sky, IPF, XP Power, Rotork, Next, Chesnara, Prudential, Cobham, L&G, Weir, Ferrexpo, Laura Ashley, PayPoint, Verdanta, Dunelm, City of London IG, Fenner	Cyclical and the portfolio has too many cyclicals