

Buying: Aggreko PLC (AGK)

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 If a company's share price shoots up quickly its shares may no longer represent good value for money, while a company that falls into a long-term decline may no longer be remotely defensive.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 January 2016 914p	Index FTSE 250	Sector Support Services
FTSE Market Cap £2.3 billion	Revenue £1.5 billion	Normalised Post-tax Profit £211 million

“Aggreko is the global leader in temporary power and temperature control solutions, operating in around 100 countries worldwide. Our business model balances our global scale with local operations to deliver fast, effective solutions.” (www.aggreko.com)

Overview

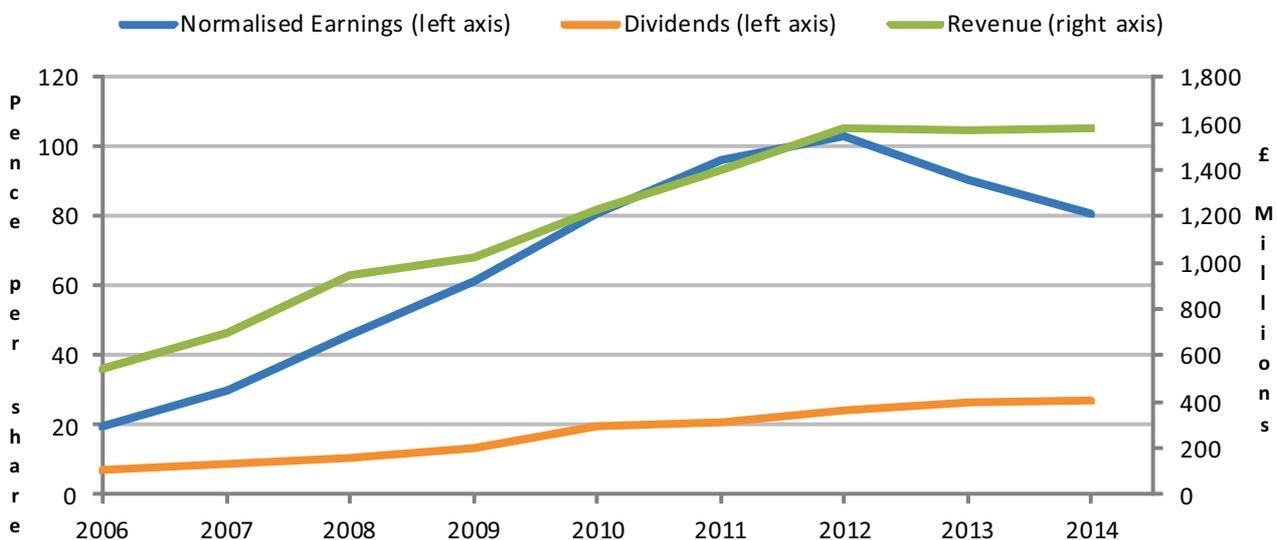
Aggreko is the world's leading provider of flexible power and temperature control solutions. In practice that means it either rents shipping container-sized power generators and temperature control units to customers or supplies power from temporary power stations which it builds by connecting multiple power generators. These services are provided to a wide range of customers in a wide range of countries on either an emergency, short-term or intermediate-term basis.

Recent examples of Aggreko's activities include supplying temporary power for one-off events such as the Olympic Games and Japan's post-tsunami recovery, to more regular events such as temporary summer cooling for oil refineries or chillers for a Christmas ice-rink.

The company was founded in 1962 in the Netherlands and in 1973 it set up operations in Scotland, where its head office, design and manufacturing operations can still be found. Between 1984 and 1997 it was a wholly owned subsidiary of another company, where it expanded into a global business both organically and through a series of acquisitions, and that process continues today.

Growth Rate 17.7% (min 2%)	Dividend Yield 3.0%	Profitability 16.3% (min 7%)	PE10 13.5 (max = 30)
Growth Quality 88% (min 50%)	Debt Ratio 2.2 (max 5)	Pension Ratio 0.4	Rank 4 (out of 235)

Green = Better than FTSE 100; Red = Worse than FTSE 100 or 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 Aggreko is a very international company and only receives around 5% of its revenues from the UK.

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

YES The portfolio currently holds 14 cyclical sector stocks. Aggreko is in the cyclical Support Services sector so it will take that number up to the maximum of 15.

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

YES The portfolio holds two Support Services companies, so Aggreko will be the third and final one for now.

Avoiding (or trying to avoid) value traps

Good management

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

YES The company's goal since 2003 has been *"to deliver long-term value to shareholders, outstanding service to customers and rewarding careers to our employees"*, and at a high level, its strategy for achieving that goal is to continue to be *"the leading global provider of flexible power and temperature control solutions"*. The company's medium-term strategy is reviewed from the ground up every five years. The most recent iteration in 2013 highlighted the following key areas of focus:

For the Rental Solutions business (covering equipment rental in developed markets): 1) Provide higher levels of service and equipment; 2) Use global scale to maximise efficiency and cost competitiveness; 3) Increase market share; 4) Extend presence in emerging markets.

For the Power Solutions business (covering power supply and rental in emerging markets): 1) Be the largest global operator to drive scale advantages; 2) Maximise efficiency and cost competitiveness; 3) Make cost of temporary power plants competitive with permanent power plants.

This strategy was expected to run through to 2017, but in 2014 a new CEO arrived and announced the inevitable *"new CEO strategy review"*.

The resulting new strategy is to focus the business on: 1) Customer – Focusing on global and national key accounts, more complex projects and adjacent markets; 2) Technology – Focusing on reducing the cost of power and being competitive with permanent power plants; 3) Efficiency – Optimising the business for cost effectiveness and taking advantage of scale.

However, despite this change to the details, the company's core strategy of being the global market leader in temporary power and temperature control remains the same.

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

YES Aggreko is a highly focused business, concentrating almost exclusively on power generators and temperature control units. The company is split roughly 50/50 into two business units:

Rental Solutions - Renting shipping container-sized power generators and temperature control units to customers in developed markets

Power Solutions - Supplying power, mostly to utilities in emerging markets, via temporary power stations made up of multiple power generators. This business also includes the rental business for emerging market customers.

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 The five KPIs mostly cover non-financial aspects of the company's performance including safety, staff turnover and customer loyalty. On the financial side the KPIs are earnings per share and return on capital employed (ROCE). Although the KPIs do not cover many financial factors, they do cover profitability via ROCE, which is perhaps the most important one.

Low costs

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

YES Aggreko is the dominant global player in both its rental and power supply businesses. There are no global competitors in the rental market, where Aggreko has a 25% market share, and there is only one (smaller) global competitor in the temporary power supply market, where Aggreko has a 40% market share in temporary utility power and 25% market share in temporary industrial power.

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

YES Aggreko has been involved in the rental side of its business for over 40 years and the power supply business has also been in place for several decades.

Caution with big projects

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

YES There do not appear to be any "bet the company" projects underway at the moment.

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

NO Before it can generate revenues, Aggreko has to manufacture a power generator or buy a temperature control unit. This means it has to spend heavily on capital assets first, before they can generate revenues and profits over many years. During periods of rapid growth, such as the last ten years, the company has to spend even more on capex to increase the size of its rental fleet. Over the last ten years Aggreko spent a total of £2.3bn on capex whilst generating £1.6bn in normalised post-tax profits. The ratio of capex to profits is above 100% so I would define Aggreko as a high capex company.

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

NO About half of Aggreko's revenues are generated from thousands of small, short-term rental contracts. The other half comes from larger, longer-term power supply contracts, which can be quite significant in size relative to the company's total revenues. The answer to this question is therefore both yes and no; however, to err on the side of caution I have chosen no as my answer.

Caution with acquisitions and mergers

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

NO Aggreko spent just 16% of its profits over the last ten years on acquisitions, so it is not a particularly acquisitive company. However, it did make a large acquisition (spent more than that year's profits) in 2006, spending approximately £100m when post-tax profits were just £50m. The acquired company was GE Energy Rentals, a multi-national supplier of power and temperature control equipment and services and one of Aggreko's largest competitors. The acquisition does not appear to have had any materially negative impacts.

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

YES The only acquisition defined as large was GE Energy Rentals, which is very closely related to Aggreko's core business.

Ability to adapt to changing market demand

11. Does the company operate in defensive markets?

NO Aggreko is listed in the cyclical Support Services sector. In terms of its actual business, on the rental side an economic slowdown could lead to a reduction in many activities which need temporary power generators, such as construction projects or oil and gas exploration and extraction. On the power supply side, Aggreko often fills the gap between the maximum power generating capacity of state-owned power plants and a country's peak power usage. If economic activity declines, the state's power plants may be able to supply all of their country's power without needing to buy power from Aggreko.

On that basis I would say Aggreko is correctly defined as cyclical, but also that it is widely diversified across industries and geographies, which may help to insulate it from economic cycles to some extent.

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 I could not find any obvious reason why the medium-term pattern of demand would change significantly for either the rental business or the power supply business.

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

YES The company expects the rental market to grow at about twice the rate of GDP growth over the medium-term, and even faster in emerging markets. As for the power supply business, which generates around 90% of its revenues from providing temporary power to national utilities, the global shortfall of utility power generation is now expected to grow by around 6% a year to 2020. 6% a year is therefore a reasonable estimate of growth in the temporary utility power supply market over the same period.

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 While the rental business does not have major contracts or products that need to be completely replaced or redesigned within the next ten years, the power supply business does. That business depends on large contracts which typically last for just a few years or less, at which point they are either renewed or cancelled. Each power supply contract can generate a meaningful portion of the company's total revenues.

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

NO In the rental business there are thousands of companies across the globe that rent out power generators and temperature control equipment. With my very limited knowledge it looks as if the equipment they provide is fairly similar and as long as availability, reliability and support are adequate I would expect price to be a primary concern. In the power supply business, Aggreko will typically have much more capability and expertise at putting together large and complex power plants than its smaller local competitors. In some ways that is a differentiating factor, but where a local or regional competitor is able to bid for a large and complex project, I don't think Aggreko's offer would differ substantially other than on price.

Indifferent to commodity prices

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

NO The impact of commodity price movements on Aggreko is mixed. For example, a significant portion of its North American business comes from companies operating in the oil and gas industry, and falling oil prices will lead to less demand for power as various projects and activities become uneconomical. In contrast, its

power supply business may benefit from falling diesel prices as it makes diesel power generators more attractive relative to other sources. Overall I think the impact of declining commodity prices is likely to be negative, but the company's diverse industrial and geographic footprint may insulate it to some extent.

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 (pre-interest and tax) ROCE of 18-21% in the rental business and 25-30% in the power supply business, and a company-wide goal of 20% or more. In recent years ROCE has declined from 32% in 2010 to 19% in 2014.

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

YES Aggreko is dependent on large projects and does require heavy investment in capital assets, both of which are risk factors that can be exacerbated by large debts and interest payments. However, even with those risk factors I think a debt ratio of 2.2 is quite low and therefore acceptable.

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

YES Aggreko is facing difficult conditions as a result of a slowdown in emerging market economies and the collapse of commodity prices and the subsequent effect on commodity-related activities. It appears that, at least for a while, the company's exceptional double digit growth rates of the last ten years and more has come to an end. As a result the share price has declined by about 60% from its peak in 2012.

However, I think these issues are likely to be temporary rather than permanent. The emerging market slowdown is not expected to last forever, and commodity prices are expected to recover, eventually. But the timing of any improvements in Aggreko's markets is impossible to forecast with any accuracy; the company may be in the doldrums for several years and few investors have the patience to wait that long.

I also don't think it's likely that profits will collapse to the point where the dividend will be cut. Even if it is, I would be surprised if it was more than a short-term capital allocation decision (i.e. if it was better to use the cash to support operations rather than pay it out to shareholders). The balance sheet appears to be strong and so a rights issue, other than for productive capital investment purposes, seems unlikely.

As is the case with most companies, Aggreko's management team is not sitting around watching events unfold. They are working to adapt the company to its current situation by focusing on areas which can sustain the company today and drive growth in the future. As a result, and accepting that the future is unknowable, I do not think Aggreko is an obvious value trap.

Uncovering competitive advantages

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

NO I do not think that Aggreko has any of these advantages.

2. Does the company gain an advantage from "switching costs", i.e. the effort required for customers to switch to another supplier (e.g. bank accounts or computer software)?

NO Once a customer's contract ends, then can switch to one of Aggreko's competitors (either for equipment rental or power supply) very easily.

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 Aggreko's services do not improve as more customers use them.

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

YES Aggreko has a significant scale advantage over its local and regional competitors. It is the only global player in the rental market and has only one global competitor in the temporary power supply market.

This gives the company various advantages over smaller competitors, from the accumulation of greater levels of experience that can be used to improve the whole business, to the more obvious advantage of economies of scale.

The company's scale also allows it to cost effectively design and manufacture its own fleet of power generators. This provides multiple advantages including efficient utilisation of the entire global fleet, retention of profits that would otherwise go to third-party manufacturers, and the ability to design and build power generators in a way that best fits the company's and its customers' requirements.

Scale advantages can be difficult to overcome if they are large enough, as the smaller competitors find it hard to compete, and therefore hard to gain market share, against the significantly more efficient larger competitor. Aggreko may well have that sort of advantages, especially in the rental market where it is the only global player and has a dominant market share.

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

YES Aggreko looks to me like a good company going through what appears to be a difficult but temporary and survivable period. I do not think it's likely that the current situation will permanently impair Aggreko's value, and on that basis I think it is attractively valued at its current price. I will be investing approximately 4% of the model portfolio into Aggreko a few days after this issue is published, and a similar percentage from my personal portfolio.

Higher ranked stocks that were not selected	Reason for not selecting
Amec Foster Wheeler	Debt ratio too high

"The strategy for the [Power Solutions] business is straightforward, and remains as it has been for the last ten years: grow as fast as we prudently can, to secure for ourselves the operating efficiencies and competitive advantages which come from being the largest global operator. So far, we have been successful in executing this strategy and our [Power Solutions] business is now many times larger than its next largest competitor."

Aggreko 2013 Annual Report

IMPORTANT NOTICE: This analysis is for information only. It is an example of how one investor applies a checklist approach to analysing a company and it should not be construed as investment advice and should not be relied upon in isolation before investing. You should always perform your own analysis and factual verification before making investment decisions. If you need advice you should seek a regulated financial advisor. See the important notes on the last page.