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THE ZULU PRINCIPLE

MAKING EXTRAORDINARY PROFITS FROM ORDINARY SHARES

JIM SLATER

"An essential building block for understanding investment"
Sir James Goldsmith

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The Zulu Principle

Making extraordinary profits from ordinary shares

by

Jim Slater

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I would not live to tell the tale unless I included Pam Hall, my long-suffering secretary, who has typed most chapters so many times that she knows some of them by heart.

Preface to the 1992 edition

One of my sons is interested in the stock market. After reading a number of quite advanced American books on investment, he asked me if I could recommend a British book of a similar nature. I searched my mind and then the bookshops, only to find that there was nothing beyond the primer stage. Market forces usually begin to fill a gap; hence my decision to write this book. I have no doubt that many others will follow.

My intention is to show you how to become a very successful investor. My problem is that I do not know if you are an aspiring trainee stockbroker; an accountant or a lawyer who has an understanding of many of the rudiments of investment; or someone who is in a very different line of business or who has retired after a lifetime in industry. I do not want to bore the people who understand the basics, so I shall assume that you are connected with the business of investment in some way or that you have read the Glossary at the end of this book. Either way, you will then know the difference between an ordinary share, a preference share and a convertible debenture; the meaning of terms like price earnings ratio, dividend yield and asset value; and the effect and significance of scrip and rights issues.

There are a number of different methods and areas of investment, some of which I will explain to you in much more detail in later chapters:

Small dynamic growth companies

Fast-growing companies with market capitalisations ranging from £5m to £100m are not researched frequently by the investment community, so their shares are often exceptionally attractive.

Turnaround situations and cyclicals

Companies that have been hit hard by a recessionary environment or other exceptional factors are often due for a rebound. These situations involve cyclical companies and those which have recently had a change of management.

Shells

Shells are another exciting medium of investment. These are often very small companies that have a quotation, a small, nondescript business of little account and occasionally some cash. Usually, the idea of the incoming entrepreneur is to obtain a backdoor quotation for his company, which has too short a record, or some other shortcoming which precludes a more conventional route. There are many examples of successful and sometimes infamous shells from Hanson and Williams Holdings to Polly Peck and Parkfield. The ride can be very exciting.

Asset situations

Some of my friends invest solely in companies in which the shares have a market value less than the worth of the underlying businesses on a break-up. These value investors wait for a trigger, such as a bid or the arrival of new management, to revitalise the assets and bring them up to their full earnings potential. The shares then begin to appreciate in value.

Leading stocks

Companies in the FT-SE 100 Index usually offer the comfort of size and rarely fail completely. These kinds of shares can also be sold much more easily even in bad markets. They are, however, well analysed by the investment community, increasing the difficulty of finding a real bargain. I intend to give you some selective criteria that should improve your investment performance with leading shares in this country. I have also found that my criteria work extremely well in America and most overseas markets.

If you need to read the Glossary please do so now, as I am anxious to show you how to make some money by using an approach that I have named 'The Zulu Principle'. You will not be spending any time on gilts, preference shares, loan stocks and the Japanese market. Instead, you will concentrate upon five different ways of making money by investing in ordinary shares before you finally select one method or perhaps two that suit your temperament.

I first named this approach 'The Zulu Principle' after my wife read a four page article on Zulus in *Reader's Digest*. From that moment onwards she knew more than me about Zulus. If she had then borrowed all the available books on the subject from the local library and read them carefully she would have known more about Zulus than most people in Surrey. If she had decided subsequently to visit South Africa, live for six months in a Zulu kraal and study all the available literature on Zulus at a South African University, she would have become one of the leading authorities in Great Britain and possibly the world. The key point is that the history of Zulus and their habits and customs today is a clearly defined and narrow area of knowledge into which my wife would have invested a disproportionate amount of her time and effort, with the result that she would have become an

acknowledged expert. The study of this noble people might not have been profitable, but there are many other very specialised subjects that would have been very rewarding financially.

I now intend to show you how to use The Zulu Principle with your investments. You will achieve your objective, like Montgomery and Napoleon before him, by concentrating your attack.

Preface 2008

The Zulu Principle explains how important it is to focus when investing. It is no good trying to be master of the universe. It is better to specialise in a narrow area and become relatively expert in it.

I have always focused on small and micro-cap stocks. The reasons are obvious – first, they are under-researched so better bargains are available and second, on average they perform very much better than larger-cap stocks. In fact over the last fifty years micro-cap stocks have outperformed the market by more than eight times.

In *The Zulu Principle* I outline the methods I was using for investing in 1992. Since then I have refined my approach a little but it is fundamentally the same.

First, I look for a tailwind. By this I mean concentrating on an area or sector which has a very favourable outlook. If you are in the wrong business at the wrong time you are bound to lose money. If you are in the right business at the right time it is very difficult not to make a lot of money.

One way of ensuring that you are in a business with a favourable outlook is to make sure that the relative strength of the sector and the stock you fancy in it is very positive in the previous year compared with the market as a whole. This is something I always check to make sure that the market does not know something horrible which is not yet public knowledge.

As part of my Zulu Principle focus I concentrate on growth shares. As I have explained, I much prefer companies with a small market capitalisation and to illustrate this I coined the expression 'Elephants

don't gallop'. I also look for shares which are a relative bargain at the time of purchase. This is determined by comparing the prospective price-earnings ratio with the forecast growth rate. Ideally you want to ensure that the prospective price-earnings ratio is well below the growth rate. For example, a company on a multiple of 15 would be very attractive if its growth rate was 30% per annum and very unattractive if its growth rate was only 5% per annum.

It is no good simply looking at one year's growth. It is vitally important that the company should have a reasonable record of growth. At the very least there should be two years' past growth and two years' forecast growth. Three years' past growth and one year's forecast growth would also be acceptable. Anything less than this would not give enough of a basis to determine that the growth is real growth as opposed to recovery from a setback.

Another very important criterion is to make sure that cash flow is in excess of earnings per share. Too many companies seem to be doing well until you analyse their accounts and find that their earnings per share are not backed by cash. They are phantom profits. By ensuring that cash flow is regularly in excess of earnings per share you can avoid the Enrons of this world.

Another vital criterion is to ensure that the directors are not selling their shares. Sales by more than one director would be enough to put me off completely, however impressive the statistics appeared to be. Conversely, it would be very bullish if several directors were buying. Particular note should be taken of buying by the chief executive and the financial director. They ought to know exactly what is happening within the business and it is always encouraging to see them putting their money where their mouth is.

About eight years ago, James O'Shaughnessy wrote a very interesting book, *What Works on Wall Street*, in which he analysed the performance of shares with different characteristics over a forty year period. He found that by following one sensible criterion such as strong cash flow or good relative strength in the previous year, you would have outperformed the market by a considerable margin. With this concept in mind, it is obviously far better to apply a combination of several sensible criteria for share selection and in *The Zulu Principle* that is exactly what I suggest you should do. Ideally I look for:

1. A strong growth record
2. An optimistic future outlook and forecast
3. A low price-earnings ratio in relation to the forecast growth rate
4. Strong cash flow well in excess of earnings per share
5. Moderate as opposed to excessive gearing
6. Positive relative strength in the previous year
7. Directors buying

As we go to press the market outlook is very uncertain. The easiest money is to be made by shorting shares with excessive gearing and diminishing prospects. The multiples on growth shares are falling but this correction is necessary to provide the basis for future exceptional gains. So be of good heart and prepare yourself for the next upswing.

May the force be with you!

Jim Slater
September 2008

1.

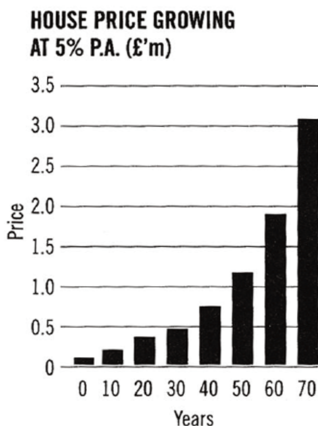
Winning

Investment is no different from any other game. Winning is much more fun than losing, and luck and skill both play their part. Bad players often complain about their luck, but as Gary Player, the famous golfer, said, ‘The harder you work, the luckier you get.’ Elmer Letterman put this another way, ‘Luck is when preparation meets opportunity.’ Let me show you how to prepare for investment and become a winner.

There is a great deal of luck in Monopoly. If you have bad dice, you might travel around the board paying huge amounts of tax and end up sitting in jail while your opponent snatches all the good sites. However, there is a small skill element in the game, and over a long period better players will win more often. Let us analyse the skill. The light blue properties – Pentonville Road, Euston Road and The Angel Islington – give the highest rental return of 159% compared with only 101% from the worst. The orange sites – Vine Street, Marlborough Street and Bow Street – are next best with a return of 141%. This yield is calculated by taking the total cost of buying all three orange sites and building hotels, which in this case is £2060, and comparing this figure with the rental on the three hotels, which would be a total of £2900. At first blush the light blue sites would seem to be better than the orange ones, but Vine Street, Marlborough Street and Bow Street are my favourites because of another important factor – the frequency with which your opponents are likely to land upon them. Firstly, there is a card in Chance ‘Go back three spaces’, and from one position this would put them on Vine Street. Secondly, the orange sites are a dice throw away from jail, which means that other players being released are more likely to land upon them. Thirdly, there are two other cards in Chance, one of which directs a player to ‘Take a trip to Marylebone Station’ and the other to ‘Advance to Pall Mall’. Following these directions bypasses the light blue sites completely and leaves your opponents poised to visit the orange sites.

A further Monopoly guideline is to build quickly once you have a complete site, even at the expense of mortgaging other incomplete sites to do so. For example, the loss of rent on the Strand would be only £18 but £100 out of the mortgage proceeds of £110 could be used to buy an extra house on Bow Street. The first house takes the rent from £14 to £70 to give a gain of £56, and the difference rises to as much as £350 when the third house is added. Subject therefore to keeping a prudent cash reserve, you should mortgage all incomplete sites and use the proceeds to build rapidly.

Before you participate in the game of investment, you should make sure that you acquire the necessary skill and that you can afford the stakes. I strongly recommend that you first invest in your own house or flat. In June 1992, property is in the doldrums, but for that reason it is a far better buy than a few years ago at the height of the property boom. As a long-term investment you can hardly do better, and there is a big bonus – you live in your house with enjoyment. Even with inflation at 5% per annum, a house costing £100,000 would tend to keep in line and, in a man's normal lifespan, appreciate in value over the seventy years to more than £3,000,000. The arithmetic is even better than this though, because most people would have an affordable mortgage, so the return on their net outlay would be much enhanced. In addition, there is still no capital gains tax on owner-occupied houses, and there is some tax relief on mortgage interest. You cannot afford to invest in the stock market before taking advantage of these privileges.



You also need to ensure that you have some money set aside for school fees, illness and a rainy day. The money that you are going to use for investment in shares has to be *patient* money that will not need to be withdrawn suddenly.

In the investment game your main problem is that you will be up against full time professionals who eat, drink and sleep investment. They have readier access to the companies in which they are likely to invest, more general information at their disposal and they are regularly bombarded with brokers' circulars and investment recommendations. In addition, brokers hoping for more business give the institutions their best possible service and keenest terms.

So you start off at a considerable disadvantage. There is a way to win, but unless you are prepared to dedicate a few hours a week to your investments, you will have no hope of succeeding. I suggest an average of at least half an hour a day – thirty minutes that I hope you will look forward to and enjoy.

To compete you need to develop an edge, so let me encourage you now with a few ideas. First you must find a market niche that is under-exploited by the professionals. Most leading brokers, professional investors and institutions concentrate their analytical skills on major companies with market capitalisations of £500m or more. The reasons for this are obvious. If a broker can produce a good argument for buying or selling a leading stock, institutions will be able to deal in volume, and a large turnover (with hefty commissions for the broker) will be the likely result. The institutions prefer leading stocks because their marketability is better. When they come to take a profit or cut a loss, they can usually deal in volume at a very keen price.

Investment is essentially the arbitrage of ignorance. The successful investor believes he knows something that other investors do not fully

appreciate. There is very little that is unknown about leading stocks, so in that area of the market there is hardly any ignorance to arbitrage. GEC, Glaxo and ICI are the subject of hundreds of brokers' circulars every year. In contrast, some smaller stocks are not written up at all and others by only one or two brokers. Most leading brokers cannot spare the time and money to research smaller stocks. You are therefore more likely to find a bargain (with some ignorance to arbitrage) in this relatively under-exploited area of the stock market. This is a possible niche for you.

The second factor that gives you an advantage over professionals is that they usually have to invest a massive amount of money. Many of them manage billions. Try to imagine some of the problems you would have looking after just a paltry £500m:

1. You would find it difficult to invest meaningfully in stocks with smaller market capitalisations. You will see in later chapters that this would be a big handicap.

2. You would have to spread your investments over at least 200 stocks and probably many more. By the time you came to your 100th selection it would be obviously less attractive than your 50th, considerably less attractive than your 10th, and infinitely less attractive than your first choice. Contrast this with managing a small portfolio in which you can concentrate upon an average of ten prime selections. A tremendous advantage!

3. As the manager of an institutional portfolio with 200 stocks or more under your control, the incidence of your own input from personal knowledge would be far less. You would be closeted in the Square Mile for most of your working day instead of being out and about with your eyes and ears open. As a private investor you have the advantage – you might notice that Sainsbury is opening

several new supermarkets or that Alexon shops are especially crowded. You might hear that a local quoted engineering company is taking on another 100 people or that a friend is delighted with his new computer. Once you begin to think in terms of your investment portfolio, any information of this nature can be an important lead. The advantage of this kind of personal awareness has to be spread very thinly across an institutional portfolio, whereas in yours it will have a major impact.

A further aid to overcoming expert competition is to apply The Zulu Principle to investment within your chosen niche market. I will show you five different approaches and suggest that you specialise in one of them. To begin with, we will look at a method of investing in relatively small companies that have shown strong past earnings growth, have future potential and appear to be rated inadequately by the market. I have profited most from investing in this kind of share and for that reason will deal with this system in considerable detail. The first ten chapters should help you to get the feel of the investment business before you progress to separate chapters on turnarounds, shells and asset situations. You should then be able to judge which approach will best suit your temperament. You need patience for asset situations and smaller growth stocks, in contrast to the more immediate pain or pleasure that will be felt by investing in shells and turnarounds. Investment in overseas markets and leading UK stocks are the subjects of separate chapters in which I set out some selective criteria for improving portfolio performance.

Let us now look at smaller growth stocks in more detail. You are searching for those that appear to be inadequately rated by the market. Sometimes there is a good reason for the market's lack of enthusiasm. Your skill element will be finding out which companies deserve a much higher rating and which do not. Needless to say, you cannot expect to

be right all of the time, but when you make a really good choice, your capital profit will surprise you and far outweigh the losses from occasional mistakes.

There are two basic reasons for growth shares increasing in price and providing you with substantial capital profits in the process. The first is the earnings growth itself. If a share is priced at ten times earnings and in the next set of results shows 25% earnings growth, all things being equal the shares will naturally appreciate by about 25%. The second reason for an uplift in price then comes into play. During the few months following the results, the market would be very likely to re-rate the shares to a more appropriate multiple, which for a company growing at 25% p.a. would be at least 20 and probably much higher. The status change in the multiple would increase your gain from 25% to 150%.

$$(100 + 25) \times \frac{20}{10} = 250$$

Less original investment	100
Gain	150

Another factor that contributes to the success of investment in smaller companies is that generally speaking elephants don't gallop. The last year or so has been exceptional, and a few elephants have charged both here and in America, whereas smaller companies have lagged behind. The Hoare Govett Small Companies Index beat the FT AllShare Index in 27 of the last 37 years. Over the last ten years, the HGSC Index under-performed the market by 6%. 1989, 1990 and

1991 were all poor years for small companies, with three successive years of under-performance occurring for the first time. This reflects the increasing dominance of institutions in the UK market and their preference for leading stocks. There is also no doubt that in recessionary times smaller companies have a higher operational risk. Nevertheless, I believe that the potential rewards more than counterbalance this, making carefully selected, small to medium-sized companies an even better buy today.

Sainsbury, one of our most successful companies, is at the time of writing valued by the stock market at about £8bn. The management will find this vast capitalisation very hard to double during the next year or so. The rating is already high at 18 times historic earnings, and most institutions have their quota of Sainsbury shares. Smaller companies have more to gain from new investors discovering them, and as their following develops, so does the share price. For example, the shares of a little company like The MTL Instruments Group (which you will hear more about later) had no difficulty in doubling in twelve months. In February 1991, the shares were 124p, with the company on a multiple of 11 times earnings capitalising at £21.7m. One year later the shares were 275p. 1990 earnings were 20% up on the previous year, and 1991 earnings looked like increasing by a similar amount. The historic price earnings ratio was re-rated from 11 to 16, and hey presto by February 1992 the market capitalisation had increased from £21.7m to over £48m.

Before we settle down to work, let me recap my recommendations to you:

1. Make a conscious decision to devote at least three hours a week to your investments.
2. Read the whole of this book before selecting an approach to investment that you feel would be most suitable for your temperament.
3. When you have selected your niche market become as expert as possible in that particular area of investment. As Warren Buffett, the legendary American investor, says, it is not necessary for an investor to know more than one thing, but he certainly has to know that.

We will now move on to look in much greater detail at my system for investing in the dynamic growth of smaller companies.

2.

Small Dynamic Growth Shares

In 1959, I was Commercial Director of AEC Limited, travelling extensively overseas. On a visit to Spain I contracted a viral illness, the after-effects of which lasted for several years. I began to worry that I might not be able to carry on with such a strenuous job for any length of time. I decided that there was only one answer – I had to build some capital and an alternative source of income.

It was no accident that I chose Stock Exchange investment. Shares could be a profitable hobby easily managed while I still retained my job. The only problem was how to become relatively expert in the chosen specialist subject.

At the time there were two weekly investment magazines, *The Stock Exchange Gazette* and the *Investors Chronicle*, now both merged under one title. I decided to apply the approach that I subsequently named 'The Zulu Principle'. To begin with I purchased two years' back copies of both magazines, and during a convalescent period in Bournemouth read through them page by page. I was convinced that the stock market winners of the past would have some common characteristics. If, with the benefit of hindsight, I could develop a formula based upon these characteristics, I was sure that I would be able to make my fortune.

I soon discovered that shares with a rising trend in earnings that also seemed to be on a relatively inexpensive multiple (earnings yield at the time) out-performed the rest of the market by a wide margin. A few failed to do so, and this made it essential to find out why and to devise some additional criteria that would help to erect a safety net under my selections.

During the following year I honed my system before putting it into practice – with astounding success. The market was in a bullish phase, which was obviously a helpful factor. As I began to succeed I gave investment advice to a number of friends, and also formed a small investment club for the executives of Leyland and AEC. I also gave investment advice to my boss, Donald Stokes, and a number of other

colleagues. Like a child with a new toy, I wrote to Nigel Lawson, who was at the time the City Editor of the *Sunday Telegraph*. He thought my ideas had merit, and asked me to write a column each month under the pseudonym of 'Capitalist'.

Nigel Lawson introduced the first article with these words:

> 'Today we welcome a new contributor to the City Pages of the *Sunday Telegraph* – 'Capitalist'. This is the pseudonym of a director of a number of well-known industrial companies in Britain and overseas who, in his spare time, has developed a highly successful new approach to investment. In this first article he explains his methods and selects the first three shares for his portfolio. In subsequent articles he will add further shares to the portfolio and review its progress to date.'

I explained in the article that I was looking for shares with an above-average earnings yield (the equivalent today would be a below average price earnings ratio) coupled with above average growth prospects, and I outlined nine important investment criteria. It is interesting to look back on them, and I quote directly from the article:

'1. The dividend yield must be at least 4 per cent.
2. Equity earnings must have increased in at least four out of the last five years.
3. Equity earnings must have at least doubled over the last four years.
4. The latest Chairman's statement must be optimistic.
5. The company must be in a reasonably liquid position.
6. The company must not be vulnerable to exceptional factors.
7. The shares must have a reasonable asset value.
8. The company should not be family controlled.
9. The shares should have votes.'

The system worked – the Capitalist portfolio appreciated in value by 68.9% against the market average of only 3.6% during the same two year period from 1963 to 1965.

Since then market conditions have changed, and I have had a further twenty-seven years' investment experience. Needless to say I have modified, improved and added to my original criteria. Let me set them out for you as they are today, broadly in order of importance, together with a few explanatory notes which will be elaborated upon in later chapters:

A positive growth rate in earnings per share in at least four of the last five years

This one is unchanged. The odd hiccup must be allowed for, but otherwise look for steady growth of at least 15% per annum. The word 'steady' eliminates cyclical stocks.

A shorter record can be acceptable if there has been a recent sharp acceleration in earnings growth which might be due to new factors, which would make the historic earnings less relevant.

A low price earnings ratio relative to the growth rate

Do not pay an excessive price for the future earnings you are buying. Look for a modest P/E ratio in relation to the earnings growth. There is an easy way of measuring the value you get for your money which is explained in the next chapter.

The chairman's statement must be optimistic

If the chairman is pessimistic, earnings growth could be at an end. Watch with bated breath for his statement and for the interim results.

Strong liquidity, low borrowings and high cash flow

Look for self-financing companies that generate cash. Avoid companies that are capital intensive and are always requiring more money for new machinery or even worse, for the replacement of old machinery at a vastly higher cost. Of course, capital expenditure is essential, but some companies simply eat cash, whereas others spit it out.

There are two ways of checking liquidity. The first is very simple – see if the company usually has a positive cash balance. Watch out for overdrafts and short-term loans on the other side of the balance sheet. You are looking for net cash. The second method is to determine the cash flow by analysing the accounts. You will learn how to do this. Meanwhile simply remember that you are trying to find companies that generate cash.

Competitive advantage

The ideal business is one you can rely upon to produce increased earnings per share year after year. This reliability is usually based on the competitive advantage of well-known brand names, patents, copyrights, market dominance or a strong position in a niche business.

Coca Cola and Guinness are examples of businesses with strong brand names and market dominance. MTL Instruments is an example of a leading company in the niche business of intrinsic safety, including anti-explosive devices. An oil company buying a safety device that would help to prevent its oil rig from blowing up would not quibble too much about the price. Photo-Me International and Rentokil are other examples of companies with strong names and distinct niches.

You are trying to identify businesses which are not operating in an over-crowded market where intense competition will erode margins. The key points are that the product or service the company is supplying should not be easy to substitute; and new entries into the industry should be hard to envisage. A quick way of obtaining an idea of a company's relative strength in its industry is to examine pre-tax profit margins and the return on capital employed.

Something new

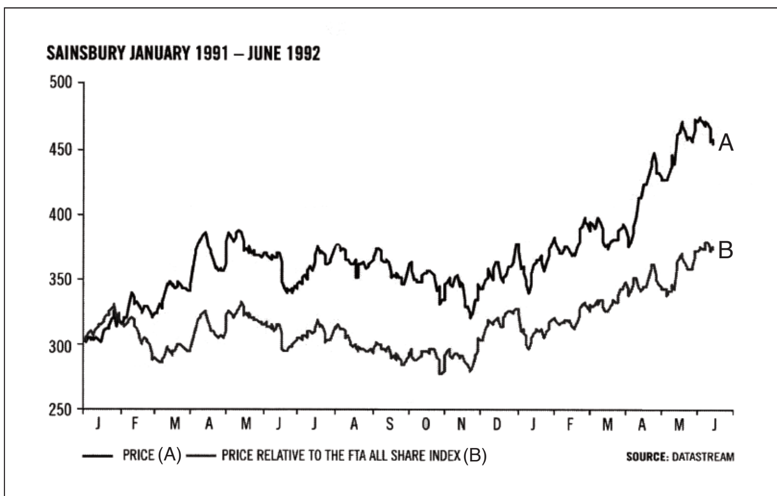
You want shares to have a story. Something new. Something that has happened relatively recently: a new factor in the industry like the failure of Harry Goodman's International Leisure Group in the holiday business, with Owners Abroad and Airtours benefiting massively from the removal of major competition; a new palm-top computer from Psion that swept the board at an American computer show. A new Chief Executive from a very successful firm like Glaxo or Hanson is one of the most reliable new factors because the benefits will be far-reaching and on-going. Greg Hutchings from Hanson joining F.H.Tomkins is an obvious and very successful example. All of these new factors are potential reasons for a substantial increase in future earnings and form the basis of the story upon which the shares will be bought.

A small capitalisation

As elephants don't gallop, you should give preference to companies with a small market capitalisation in the region of £10m-£50m, with an outside limit, in most cases, of £100m.

High relative strength of the shares compared with the market

Sometimes shares perform poorly in the market in spite of very appealing fundamentals. Other investors may be selling after becoming aware of problems that you have not yet identified. Your broker should be able to let you have copies of Datastream charts (like the one below) showing the relative performance of your chosen shares against the market. If the shares are not keeping up with the market, you should be on red alert. At the time of purchase, as a quick rule-of-thumb cross-check, make sure that the growth shares you select are within 15% of their maximum prices during the previous two years.



A dividend yield

The dividend yield can be well below my original 4%, provided that dividends paid are growing in line with earnings. Some institutions or funds will not invest in the shares of companies which do not pay dividends. We are anxious not to preclude any of them from participating in our selections.

A reasonable asset position

Very few UK growth shares in a dynamic phase are priced near to or below book value. Although you should welcome the comfort of a strong asset position, remember that book values are often unreliable. A property value could easily be overstated, whereas an excellent brand name may be in the books for next to nothing.

Management should have a significant shareholding

You want the Directors to have a significant shareholding in relation to their personal finances – the actual amount of money involved is relatively unimportant. You are looking for shareholder-orientated management that will look after your interests with the 'owner's eye'. Avoid companies which still have two classes of shares, one of which gives extra votes to management. The ideal scenario is for management to have about 20% of the company so they are highly motivated but cannot block a bid.

There is no doubt that out of all of the above factors, the one that matters most is the relative cheapness of the P/E ratio in comparison with the growth rate. As you will see in later chapters many of the other criteria help to form a protective safety net around this fundamental requirement.

Before we progress any further let me whet your appetite with an example of a share that fulfilled my criteria in early 1991. As mentioned earlier, MTL Instruments is in the growing business of making safety devices for oil rigs, boiler rooms and chemical plants. Let us check off the statistics as they were in March 1991:

Investors Chronicle

MTL Instruments

Electronic explosion prevention devices

Fairly priced

Ord price: 150p	Market value £26.3m
	1991-2 High: 150p Low: 118p
Dividend yield: 2.5%	PE ratio: 11
Net asset value: na	Net cash: £4.7m

Year to 31 Dec	Tumover £m	Pre-tax Profit £m	Stated Earnings per share (p)	Gross Dividend per share (p)
1987	7.5	1.79	6.8	nil
1988	9.3	2.31	8.6	2.67
1989	11.9	3.08	11.3	3.20
1990	14.0	3.77	13.7	3.73
% Change	+18	+23	+20	+17

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MTL seems to grow effortlessly year by year. The clear winner in 1990 was work on North Sea oil rigs, which accounted for around half UK turnover, in turn about a third of the total. Overseas trading saw good performances from newly established businesses in Australia and New Zealand and from India. where local manufacturing has begun. Profits also benefited from a £216,000 increase in interest receipts to £743,000.

“Good progress” is also forecast for 1991 and MTL’s preliminary statement lists a number of products that have recently been launched. Trading may slow this year, but the group seems determined to maintain real returns of 12 per cent on sales and profits. **The shares are certainly not expensive**.

1. Positive Five Year Record

Earnings per share grew as follows:

1986	1987	1988	1989	1990
5.1p*	6.8p	8.6p	11.3p	13.7p

*Available from the offer document

You can readily see that earnings were increasing at over 20% per annum.

2. Low P/E Ratio in Relation to Growth Rate

At 150p the shares were priced at 11 times 1990 earnings and at 9.5 times the forecast for 1991. Earnings per share had grown at more than 20% compound since 1983, 21% in 1990, and the company was determined to grow at 12% in 'real terms' in 1991. With inflation running at 8.7% in March 1991 this could be interpreted as at least 20%.

3. Optimistic Chairman's Statement

In his statement the Chairman said that he was 'confident that MTL will continue to make good progress.' Brokers' forecasts, new product developments and an expanding market also supported his view.

4. Strong Liquidity, Low Borrowings and High Cash Flow

MTL enjoyed a superb financial position, with £4.7m net cash (equivalent to 18% of market capitalisation) and a strongly cash generative business.

5. Competitive Advantage

With 60% of the UK market and 25% of the world market, MTL could safely be said to have a powerful position in the niche industry of manufacturing intrinsic safety devices.

6. Something New

There was nothing 'new' except the company's innovative policy and a growing acceptance of the need for intrinsic safety. Given the company's very strong showing on all the other criteria, this was not a cause for concern.

7. Small Market Capitalisation

With the shares at 150p MTL was capitalised at £26.3m. Small enough to have been overlooked by institutions.

8. High Relative Strength

At 150p the shares were on their high.

9. Dividend Yield

Steadily rising dividends since one was first paid in 1988. The historic yield was an acceptable 2.5%.

10. Reasonable Asset Position

Net assets per share stood at 52p, just over one third of the share price. Not very attractive in their own right, but passable for a growth share.

11. Management Shareholding

Directors, families and associates held 55.5% of the shares with a value of over £14.5m. Clearly the Directors could block a bid but they would certainly have the 'owner's eye'.

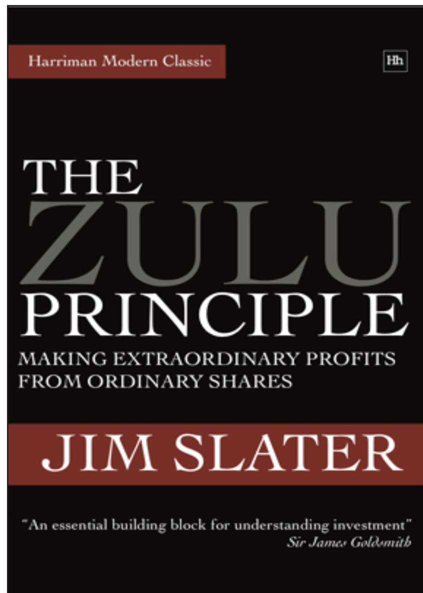
As you can see most of my criteria were well satisfied, the main exception being 'something new'. One year later, in March 1992, the shares had risen from 150p to 295p, giving a capital gain of 97% compared with the dismal performance of the market average of less than 5% during the same period. Increased earnings made a contribution to the gain but the major factor was the status change in the multiple.

MTL was an easy choice as most of my criteria were so obviously satisfied. Frequently, your decision will be much more difficult as your selection may not measure up on every count. You will need to know the criteria upon which you can place the most reliance and those that are less important. To this end, we must move on now from the stark outline I have given you to a much more detailed understanding of each of the criteria.

The Zulu Principle

Making extraordinary profits from ordinary shares

Jim Slater



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