fatPROPHETS™ 1300 881 177

Intertek

24/11/2016 **FAT-UK-662**

ITRK

GBP £32.20 Core **LOW** **B**

Safety in testing

We have reviewed the global testing sector in a separate special report and consider it worth looking at Intertek more closely. The company is the third largest testing company by revenue and has a strong track record. Intertek is on track to deliver robust revenue growth in 2016 and our rating is buy.

In February 2016 we issued a special report (FAT UK 622) on Compounding Sectors and Stocks. To compound a stock or sector has to retain and grow value over time and as such investments are typically in high quality areas.

This approach usually holds an investment for the long-term or at least while the underlying business franchise is able to retain value. This is different from the approach of buying low and then selling high in lower quality stocks/sectors.

The trouble with buying into lower quality areas, even if they are cheap, is that they typically have a number of significant risk factors. This means that they can “blow up” while an investor is waiting for value to come through.

The best investments are non-cyclical, compounders

	Cyclical – timing helps	**Non-cyclical**
Blow-up risk	A disaster waiting to happen!	Likely to blow up at some point
Compounder	Ok but volatile	Great!

Source: FAT UK 622 Special Report

The higher quality compounding stocks should be more forgiving as there shouldn’t be scope for long-term value destruction. A company like **Nestle**, for example, will be able to bounce back from short-term product issues.

In our report in February we identified 15 FTSE 100 stocks that appear to have compounding potential. Ten of these are already held in the Fat Prophets portfolio and we have exposure to most of the compounding sectors identified.

Sectors that offer compounding potential and where we have little exposure are payment processing, testing and hotel franchising. The FTSE 100 companies in these sectors are **Worldpay**, **Intertek** and **Intercontinental Hotel group**.

Testing is an area where we have no exposure in the UK report with it dominated by a few global players. **Intertek** is one of these and is notable by the lack of financial media coverage it receives in the UK.

This is a positive sign as it suggests that the underlying business is resilient and not subject to major setbacks. Companies like this tend to be expensive but Intertek's forecast P/E of 17.8X for 2017 is not overly demanding in our view.

The most recent trading update for the first ten months of 2016 was mixed with a revenue decline in the resources division. However, total revenue was up 10% on a year ago at constant exchange rates and 18% at actual exchange rates.

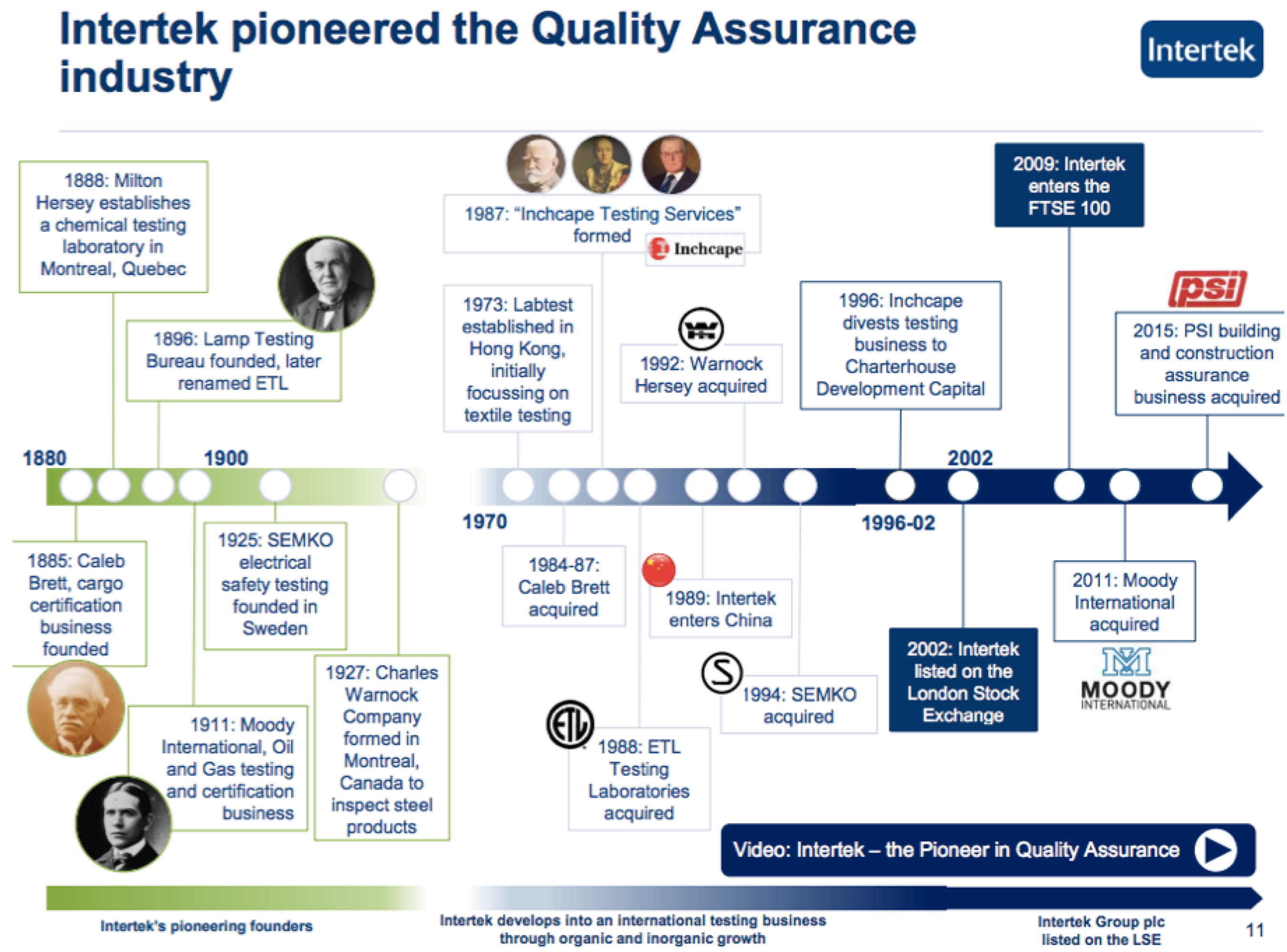
Turning to the daily chart, structural support was respected at the 3084p region (horizontal blue line), which is a positive event. In order for the short-term technical outlook to strengthen, a sustained break above the 50-day moving average (red) of 3362p is required. Should this occur, then further gains are likely over the near term, on the back of a firm long-term uptrend.

With reference to the weekly chart, a cluster of support is being tested at between 3109p and 3235p. This is made up of the 38.2% Fibonacci retracement and the 50-week moving average (red). A definitive break above this zone would strengthen broader term upward momentum. Should this scenario unfold, then a resumption of the long-term uptrend is expected.

Intertek's history

Intertek has its roots in a number of businesses that provided testing services in different areas. The oldest of these is a marine surveying company that was formed in the UK in 1885 by Caleb Brett.

In 1888 Milton Harvey established a chemical testing lab in Quebec and in 1896 the Lamp Testing Bureau was founded in the USA. The later was founded by Thomas Edison and was later renamed Electrical Testing Laboratories (ETL).



Source: Intertek website

In the 20th century the SEMKO company was founded in Sweden in 1925 to provide electrical and electrical product safety testing. Moving back to Canada and in 1927 the Chas Warnock company was founded to inspect steel products.

Notable developments in Intertek's history include the company's entry into China in 1989. The group listed in London in 2002 and entered the FTSE 100 in 2009 and is in the blue chip index today.

Intertek today

Looking at Intertek today and the group breaks down its business into three areas: Products, Trade and lastly Resources. The Products division generated 72% of first half 2016 profit, Trade came in at 20% and Resources at 8%.

Intertek's first half 2016 profit breakdown and drivers

Source: Intertek investor presentation

The Products area covers a range of sectors from building & construction, transportation technologies to food, chemicals and pharmaceuticals. This area generates the highest margins for the business at 19.1% in H1 2016.

The Trade division covers agriculture, cargo & analytical and lastly government agencies. This area is driven by GDP growth and related global and regional trade flows and had a first half profit margin of 13.6%.

The Resources division focuses on mineral companies and firms providing industry services. The division provides services for the investment spending made by companies in this sector and had a first half profit margin of 6%.

Divisional drivers

Looking at Intertek's **Product division** and the business drivers are both on the consumer and the corporate side. Recent consumer trends include a shift towards sustainable products with ethical sourcing.

On the corporate side the need to protect a brand and company reputation has become more pronounced. Social media has allowed poor customer service and product failures to rapidly reach a large audience.

Product division: structural growth drivers

Source: Intertek investor presentation

Taking a sub-sector example and mobile phones have seen a significant increase in terms of annual production. There has also much more choice and complexity in products then there was when the devices first came out in the 1980's.

The issues in a number of mobile phones that have been released in recent years also make the product a good case study. Apple had reception issues with its iPhone 4 while Samsung has seen its Galaxy Note labeled as a fire hazard.

Mobile phones: increased production, choice and complexity

Source: Intertek investor presentation

Turning to the **Trade division** and the drivers are global GDP growth and the increase in globalization. While there is a backlash against globalization at present but we are unlikely to see the rise of protectionism anytime soon.

Trade division: structural growth drivers

Source: Intertek investor presentation

Looking lastly at the group's **Resources division** and the sector has seen weakness recently. However, much of this has been a supply side issue with demand for oil, for example, continuing to increase.

However, the resource intensity of global output is likely to fall over time as the service sector takes a larger share. New areas of growth for the resources division are for commodities used in electric cars and solar panels.

Source: Intertek investor presentation

Intertek's business model

Turning to Intertek's business model and the growth in its three divisions is expected to translate into GDP+ organic revenue growth. This is mainly due to the Products division, which is expected to growth at a GDP+ rate.

The group is also targeting margin accretive revenue growth with the Products division being a key focus on account of its high margins. Investments in capital spending and M&A are targeted to boost the underlying growth rate.

Source: Intertek investor presentation

Earnings model in action: 2015 results

Source: Intertek investor presentation

Intertek's recent performance

Intertek reported modest organic revenue growth at constant currency rates in the first half of 2016 at 0.5%. Looking at the 2015 financial year and organic revenue growth at constant currency rates improved by 1.6%.

However, reported revenue in the first half of 2016 improved by 13.6% due to acquisitions and a currency tailwind. The low organic growth rate of 0.5% was due to a weak result in the Resources division and the trade division.

First half results: 0.5% organic revenue growth

Source: Intertek investor presentation

The latest trading update for Intertek covers the 10-month period from the start of 2016 to the end of October. The Products and Trade divisions delivered 4% organic growth at constant exchange rates and represent 90% of group earnings.

The Resources division has remained weak with organic revenue at constant exchange rates down by 13% on a year ago. This compares to 5.5% growth in the Products division and a 1% improvement in the Trade division.

Constant currency revenue, including acquisitions, came in at 10% while reported revenue improved by 18%. Intertek reports results in sterling and has therefore seen a translation tailwind since July given the fall in the value of the pound

Balance sheet and M&A

Intertek has a target for balance sheet leverage of net debt to EBITDA between 1.5X and 2X. This is relatively low given that the underlying business is low risk with resilient demand.

Intertek has grown in no small part through acquisitions and this is unlikely to halt in future. Normal capital spending is targeted at 5% of revenue while M&A activity will be focused on "strong growth and margin prospects in businesses."

Source: Intertek investor presentation

Summary and valuation

Intertek has a relatively low profile given its position in the FTSE 100 and the company's track record. This is because unlike a company such as BP the business is low risk and tends to generate few headline grabbing updates.

The performance of National Grid, a dull company if ever there was one, highlights that boring can be great for investors. It translates into an ability to slowly plod along and compound value.

Recent acquisitions have seen Intertek cement its third place position in the global testing sector. The focus on Assurance, in addition to TIC, should also help the group to steal a march on rivals.

Recent trading results have, however, been weak with organic constant currency revenue growth at 1.6% in 2016 and 0.5% in H1 2015. This was partly due to weakness in the Resources segment given the downturn in commodity prices.

The ongoing recovery in a number of commodities, such as copper and iron ore, bodes well for future investment. In any even the Products and Trade segments generate around 90% of Intertek's group profits.

Turning to the valuation and high quality companies always appear to be expensive with Intertek on a forecast P/E of 20X for 2016. However, this figure falls to 18X in 2017 and then 16.6X in 2018.

This is relatively low versus a company such as Reckitt Benckiser and the multiples are also lower than for industry leader SGS. With the Resource segment likely to rebound there may be scope for earnings upgrades.

Accordingly, we recommend Intertek as a low risk buy to all members.

Suisse, D.R. Horton, Dai-Ichi Life Holdings, Daikin Industries, Danone, Dr. Reddys Laboratories, ENAV, Euronext, Fanuc, FedEx, Fresnillo, Fukuoka Financial Group, Glanbia, Google (Alphabet), Heidelberg Cement, Heineken, ICICI Bank, Inpex Corporation, James Hardie, KONE Corp., Lennar Corp., LVMH, MGM China, Mitsubishi Corp., Mitsubishi UFJ, Mitsui Fudosan, Mizuho Financial Group, Nintendo, Nippon Telegraph and Telephone, Nissha Printing Co., Nomura Holdings, Panasonic, PICC Property & Casualty, Powerhouse Energy, PPHE Hotel Group, Randgold Resources, Reliance Industries, Resona Holdings, Riverstone, Royal Dutch Shell, Sands China, Societe Generale, Sony Corporation, SPDR Gold Trust ETF, Square Enix, Sumitomo Chemical, Sumitomo Mitsui Financial Group, Tata Motors, TE Connectivity, Telepizza, Tencent, THK Co., Toyota Motor, VanEck Vectors Junior Gold Miners ETF, Volkswagen, Walt Disney, Wynn Macau, Wynn Resorts, XTD, Yaskawa Electric, Zillow. These may change without notice and should not be taken as recommendations.

Snapshot ITRK

Intertek

Latest Closing Price: £32.20

Intertek Group plc is engaged in providing assurance, testing, inspection and certification services. The company's client base is split into three areas: Products, Trade and Resources.

Market Capitalisation:£5.2bn

	FY1	FY2
Price to Earnings	20	18
Dividend Yield (%)	1.9	2
Price to Book	11.1	8.4
Return on Equity (%)	67.2	52.5
EV/EBITDA	12.2	11