Red flags in the Wild West of investing

by Christopher Boxall

Despite its "Wild West" reputation, investing in stocks listed on Aim can be very profitable if you choose wisely. Many of the serial underachievers of old have now departed the market. But whether investing on Aim or the main market, it pays to be alert to signs of danger. Below I look at two Aim stocks that have run into trouble and highlight the red-flag warning signs that could have saved alert investors a lot of grief.

Superglass: the dangers of debt

1: A private equity sale
Private-equity shareholders effectively acquired insulation manufacturer Superglass Holdings in 2005 for a modest, largely debt-funded sum. In 2007 they sold out for £70m when Superglass listed on the main market at 180p a share – a great return, given that they didn't put up much of their own cash in the first place. The new shareholders didn't do so well.

2: High debt levels
When Superglass listed, it was carrying £30m of debt. Its balance sheet indicated net assets of just £1.6m, and gearing of more than 1,500%. The high level of debt meant there was little balance-sheet support for the company's valuation in the event of an economic downturn – which, of course, occurred.

3: Government incentives
Before listing in 2007, Superglass made great returns for what was essentially an old-line manufacturing business. But this was only with the aid of government initiatives to cut carbon-dioxide emissions and other regulatory changes at a national and EU level. Such support was never going to continue without periodic delays, and it didn't.

4: Unusually high profit margins
The strong growth and high profits on offer attracted lots of rivals, driving down prices across Superglass's market.

5: Underinvestment
Having too much debt means any cash made from operations goes mainly on repaying lenders. In the years ending August 2008 to 2010, depreciation and amortisation (see below) for Superglass totalled £18.2m. Yet investment in new plant was just £4.2m, with interest and debt repayments of £13.6m. This underinvestment contributed to a furnace at Superglass's Stirling plant failing in June 2010, hitting sales, and reducing group profits by around £0.9m.

6: A move from the main market
A business that's struggling on the main market won't turn into a superstar just by moving to Aim, which is what Superglass did after six disastrous years. Three years later shareholders were put out of their misery with a takeover at a mere 5.6p a share.

Stanley Gibbons: cash flow matters

7: A changing business model
Stamp and collectables specialist Stanley Gibbons is an old name in the philatelic world, and a business that used to deliver consistently strong results. Previously it largely facilitated trading in collectables – effectively acting as a broker – and as such didn't carry much inventory risk. However, everything changed a few years ago as the company began investing in its own stock of stamps and collectables.

Don't come a cropper: do your homework

8: Growing inventory levels
In adopting a position as "principal", Stanley Gibbons's business model changed dramatically as huge amounts of capital were tied up in its own stock. Between 2009 and 2015, the company's inventories rose to £54m from £9m, while debt ballooned. Having cash tied up in growing and slow-moving inventory – which is very hard to value accurately – is generally a sign of impending disaster.

9: Negative cash flow
As the old stockmarket saying goes, "Revenue is vanity. Profit is sanity. Cash is reality." Stanley Gibbons saw revenues jump and it remained profitable until its most recent financial year. Yet the firm had started haemorrhaging cash several years previously, due mainly to its growing inventory levels. Those watching cash flow could have spotted trouble coming from a long way off.

10: A weak online offering
To do well in retail today, a company needs a strong online offering. Stanley Gibbons's web offering took ages to develop, at a relatively high cost. A better website would have supported faster inventory turnaround, boosting cash flow.

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I wish I knew what depreciation was, but I'm too embarrassed to ask

If you buy a van or a computer or another piece of equipment for your business, then it will wear out as it gets older, and it will eventually need to be replaced. The asset is therefore "depreciating" in value over time. This depreciation needs to be reflected in a company's accounts to allow for the wearing out of any assets in the accounting period. There are several ways of depreciating the value of an asset. The "straight line" method allows for a fixed and absolute amount of the value of the asset to be written off each year. "Reducing balance" depreciation, on the other hand, means that a set percentage of the remaining cost of the asset is written off each year.

In each case, profits are reduced a bit, and so is the value of the assets on the balance sheet. Note that this is separate from the cash flow – depreciation does not reflect cash coming in or out of the business, but rather a change in the value of its assets. Depreciation applies to tangible property, such as machinery and buildings. When applied to intangible assets – such as goodwill arising from an acquisition – the term used is amortisation. Depreciation and amortisation policies can sometimes be used to flatter profit figures, which is why it pays to look closely at measures such as cash flow as well as profit before deciding whether to invest in a particular company.

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