



# Detecting a growth story

Laboratory equipment and testing company Celsis is a riskier-than-usual pick by our resident sleuth. **Richard Beddard** explains why it appeals

One of the maxims of private investment is 'buy what you know', a phrase endorsed and then regretted by legendary fund manager Peter Lynch. People took it to mean they could buy shares in any company they liked, regardless of whether the business was any good or the shares were suitably priced.

Most Share Sleuth companies are readily understandable, but sometimes straying into new territory is desirable if it increases our knowledge, diversifies our portfolios and makes us money. But overreaching can be a mistake. In profiling Optare (*Money Observer*, September 2008), for example, I broke my usual rules and the shares fell 75 per cent.

This month, I've been seduced by Celsis. It has a reasonably long record of profitability and is financially strong, so it's less of a leap out of my comfort zone. However, because Celsis supplies other companies with technical equipment and services it's difficult for the generalist investor to evaluate what it sells.

While 'buying what you know' is not the be-all and end-all, it helps. Without first-hand knowledge we are more reliant on the numbers and the profits, which demonstrate that Celsis has something worth selling.

### Three is the magic number

Celsis is three businesses. The biggest, Rapid Detection, makes machines that test drugs, foods and household products for bacterial contaminants. As with printers and ink, most of the revenues come from the consumables – the reagents or chemicals used in the testing.

The second biggest, Analytical Services, does laboratory testing and the third, In Vitro Technologies (IVT), a company it bought for \$30 million in 2006, supplies liver cells to researchers screening drug compounds for toxicity.



Recession vaccination: Celsis has grown its profits

Although it's the smallest business, IVT earned 20 per cent of revenues in 2009.

All three are struggling to increase sales in the recession, but Celsis managed to grow its profits in the year to March 2009 by reducing costs and disposing of an unprofitable business.

The biggest risk may be the most unfathomable one since it involves the future – how Celsis uses its profits. Last year, as in previous years, it chose not to pay

a dividend, but paid off the loan used to finance the acquisition of IVT and fund growth. Although the company's earnings per share have grown by about 20 per cent in five of the past six years, that trend is not assured because it depends on uncertain variables from the state of the economy to competition and how wisely its management invests.

From a value investor's point of view, if it's worth paying extra for a record of growth, it isn't worth paying much extra because of the uncertainty. That's why Celsis is interesting. The share price is about 12 times earnings averaged over the last seven years, which is only two

points above my arbitrary benchmark for an absolute bargain (less than 10 times earnings).

But here's the sting in the tail: the seven-year average ignores a lean year in 2001 and losses in 2002 when current chief executive Jay LeCoque and financial director Christian Madrolle restructured Celsis around Rapid Detection. Include those years and you get a less charitable nine-year price/earnings ratio of 14.

By ignoring these two years I'm assuming the apparently steady hands in charge won't blunder. As the company is looking for more acquisitions, one way management could invest unwisely is by paying too much for a business that earns less profit than they expect.

Celsis has entered the recession in good health and the shares look cheap. In making only one acquisition in his tenure LeCoque has been fairly judicious, so I'm inclined to give him the benefit of the doubt.

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### Key stats The PEG ratio

Peter Lynch used the PEG (price earnings growth) ratio to value growth companies and Jim Slater popularised it in the UK in his book *The Zulu Principle*. To calculate the PEG you divide the p/e ratio of a company by the annual rate of growth in earnings per share. A company on a p/e ratio of 10, growing at 10 per cent a year has a PEG of one, which is the benchmark for value. Less than one is cheap.

The PEG is a good formula, but it may not be that useful. Dr Keith Anderson, a lecturer at York University and expert on the P/E ratio, says there's no evidence it works. Anthony Bolton, another fund management legend, criticises it in his book *Investing Against the Tide*. Experience tells us growth can't be relied on, but value can.

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