Buying: XP Power Ltd (XPP)

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 If a company's share price shoots up quickly its shares may no longer represent good value for money, while a company that falls into a long-term decline may no longer be remotely defensive.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 (31/01/2017)	Index	Sector
1,810p	Small Cap	Electronic & Electrical Equipment
FTSE Market Cap	**Revenue**	**Normalised Post-tax Profit**
£346 million	£110 million	£20 million

"XP Power is committed to being a leading provider of power solutions, including AC-DC power supplies and DC-DC converters. The company offers the widest range of power products available from one source and unrivalled technical and customer support." (www.xppowerplc.com)

Overview

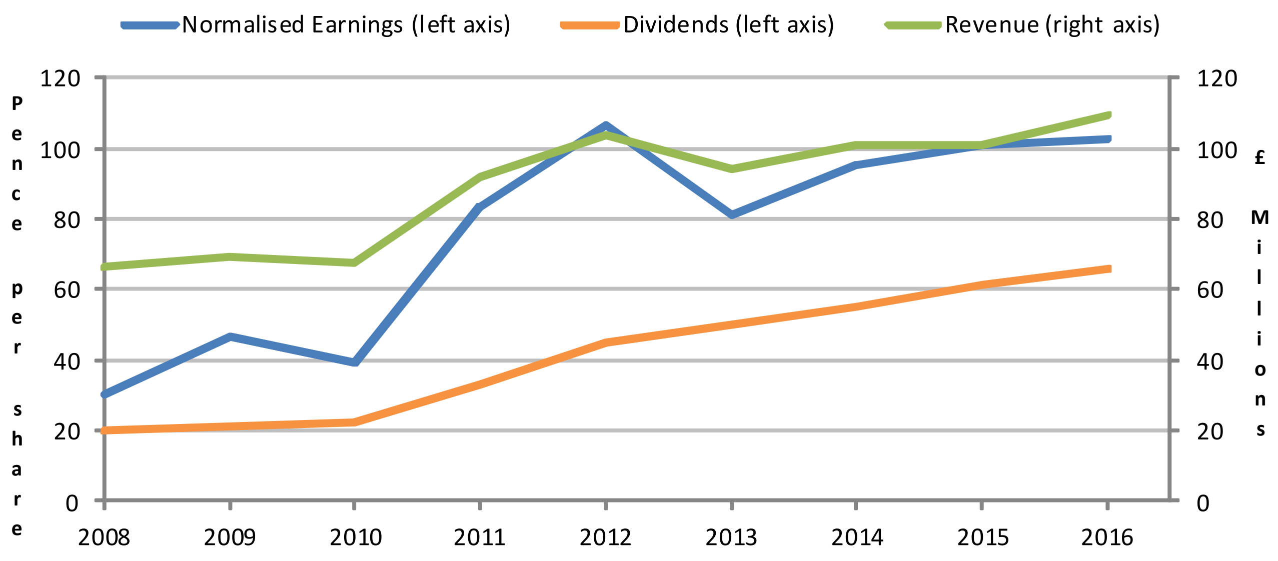
XP was founded in 1988 by current Chairman James Peters as a distributor of AC-DC, DC-DC and other power converters. In the company's own words these power converters "take the relatively high voltage alternating current output from the mains supply and converts it into various lower voltage, stable direct current outputs that are required to drive most electronic equipment".

Distribution is a low margin business and so in 2000 the company took its first major step beyond distribution by purchasing a US competitor which had in-house engineering capabilities. This allowed XP to work more closely with clients who needed help integrating various power converters into their own products. In 2002 XP purchased another company, this time with its own product line and in-house design team. This journey of "vertical integration" was completed in 2006-2008 when XP entered into and then bought out a manufacturing joint venture in China. An additional manufacturing facility in Vietnam went live in 2012.

Today almost 70% of XP's revenues come from products designed, manufactured, customised in-house, and XP has grown to be one of the world's leading international suppliers of power solutions.

Dividend Yield	PE10	Growth Rate	Growth Quality	Profitability
3.7%	23.6 (max = 30)	14.6% (min 2%)	79% (min 50%)	21.6% (min 7%)
Debt Ratio	**Pension Ratio**	**Capex/Profit Ratio**	**Capex/Depr. Ratio**	**Rank**
0.5 (cyc. max 4)	0.0 (max 10)	29% (max 100%)	189% (max 200%)	19 (out of 227)

__Green__ = Better than FTSE 100; __Pink__ = Worse than FTSE 100; __Red__ = 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 XP generates 51% of its revenues from North America, 41% from Europe (including 22% from the UK) and 8% from Asia. This will help reduce the portfolio's UK exposure, which is already below 50%.

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

NO As has been the case for quite a while now, attractively valued defensive sector stocks are few and far between. As a result the portfolio already has 16 holdings from cyclical sectors. XP is from the cyclical Electronic & Electrical Equipment sector and so XP will push the number of cyclical stocks up to 17. I will try to buy a defensive sector stock next, but will only do so if there is one available at an acceptable price.

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

YES XP will be the first holding from the Electronic & Electrical Equipment sector.

Avoiding value traps

Good management

1. Does the company have an obvious and dominant core business?

YES XP's core business is the design, manufacture and distribution of power converters and other power control devices, primarily selling direct to customers. Its main focus is original equipment manufacturers (OEMs) in the industrial, technology and healthcare markets.

2. Does the company have a clear and consistent goal and strategy?

YES XP Power has followed the same basic strategy in the pursuit of maximising shareholder returns for many years. That strategy is to become a leading preferred supplier of power converters to large and international blue chip OEMs in the industrial, technology and healthcare markets.

The focus is on large and international blue chip OEMs because the barriers to entry are higher which leads to better profit margins, assuming a company can get over the barriers itself in order to access those higher margins. Another benefit of the OEM market is that once a power converter has been designed into the customer's end product the supplier then signs a long-term supply contract giving it a steady "revenue annuity" which typically lasts for around five to seven years. And finally, once a company becomes a preferred and trusted supplier to a particular OEM it is then much easier for the company to get more of its widgets included in that customer's other new products.

International blue chip OEMs want several things from their power converter suppliers. They want suppliers that can: 1) Help them differentiate their products with power converters that are tailored to their specific needs (e.g. by focusing on size, cost, sound, temperature, efficiency or reliability); 2) Move from analysis to prototype to production rapidly in order to avoid delay in the customer's product development process; 3) Provide international support across all stages of the sales cycle; 4) Be reliable over many years.

XP now fulfils all of these criteria with engineering and sales teams in North America, Europe and Asia, supported by the industry's largest direct sales force and industry-leading low-cost manufacturing facilities. This has led to XP picking up major contracts with an increasing number of large blue chip clients over the years and currently its top 30 customers generate more than 44% of the company's revenues (and in order to control risk, no one client generates more than 7% of the total).

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?

NO The headline KPIs are: "Number of new product family releases", "Green product revenues", "Own design revenues", "Proportion of own design revenues" and "Earnings per share". These are entirely reasonable KPIs, but I would like to see some mention of profitability, capital investment and so on. This isn't a major problem though as I don't have any issues with the company's level of profitability, debt or capex.

Low costs

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

YES XP operates in a wide range of markets in which the usual rule of five or so big suppliers does not seem to apply. Apparently this is because there is an enormous variety in what customers require from their power converters, and that in turn makes it difficult for any one company to satisfy a large portion of the market.

Having said that, XP has a 9% share of the available North American market, 12% in Europe and 1% in Asia, so it is a significant player in two of its three geographic markets. The company also describes itself as "a leading international provider of essential power control solutions", has the largest sales force in the industry and has some of the best products and manufacturing facilities in the industry, even if it does say so itself.

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

YES XP has been in the power convert distribution business since 1988, in design since 2002 and in manufacturing since 2006. I think that just about reaches my definition of "many years".

Caution with big projects

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

YES There are no major "bet the company" projects planned or underway as far as I can see.

7. Has the company avoided dangerously large capital expenditures (capex)?

YES XP is a relatively capital light business, with capex equal to 29% of profits over the last decade (I consider anything below 50% as low capex). On the other hand, the amount spent on capex has been almost double the amount of depreciation on average, which means it has been expanding its capital base quite rapidly. That can be a sign of overinvestment, especially if the industry has a pronounced capital investment cycle (i.e. goes through long periods of high profits and aggressive capital investment followed by long periods of weak profits or losses and outright underinvestment).

In this case though, XP's capex/profit ratio and its capex/depreciation ratio are not high enough be an obvious problem.

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

NO Although XP makes millions of small widgets, they are for the most part sold as part of a multi-year contract between XP and a particular customer. Contract-based businesses can be riskier than companies selling large numbers of individual small-ticket items because contracts eventually need to be replaced. If a contract is very large then there can be a catastrophic loss of revenues when it expires, which the company may or may not be able to replace.

For XP this doesn't appear to be a huge problem because its largest customer makes up just 7% of revenues, and XP has many different contracts with that customer spread across many different product lines. So there are no individual contracts that pose a significant risk.

Caution with acquisitions and mergers

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

YES XP has not made any large acquisitions in the last decade (large meaning the cost of the acquisition was greater than the company's average profits at the time).

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

YES There have been no large acquisitions. The only acquisition of note was in 2015, when XP completed its acquisition of EMCO, a specialist in DC-DC power converters. EMCO's core business is closely related to XP's core business.

Ability to adapt to changing market demand

11. Does the company operate primarily in defensive markets?

NO XP's revenues are split fairly evenly across three sectors (industrial, healthcare and technology) and these have varying degrees of cyclicality and defensiveness. The technology sector is very cyclical, industrial is somewhere in the middle and the healthcare sector is very defensive. I think this spread of end-markets is good as it can lower overall risk and increase the company's ability to invest during downturns in its more cyclical markets.

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 can't see any obvious reason why the existing patterns of demand (blue chip OEM's looking for trustworthy preferred suppliers who they can work with over many years) will change significantly.

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

YES XP lists its market growth drivers in the latest annual report. I think the key drivers are: 1) **Proliferation of electronic devices.** The way things are going, just about everything (including people) will have electronic widgets implanted into them, and those widgets need a converted power supply; 2) **"Green" power converters.** These high efficiency, high reliability, low sound and low heat converters now generate 22% of the company's revenues and income from these products is growing at more than 25% per year. Continued growth is expected as climate-related legislation pushes up minimum power efficiency standards; 3) **An aging global population.** People just keep living longer, and older people require more electronic devices to keep them alive and healthy.

Competitive product, service and price

14. Has the company avoided generating a significant portion of its profits from a single product line or contract that needs to be replaced within the next 10 years?

YES XP has thousands of products, none of which generate a large portion of its revenues. The same is true of its contracts to supply power converters for various customer products. As I mentioned earlier, its largest customer generates 7% of revenues, which isn't a huge amount in my opinion and is made up of many contracts across many products.

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

YES XP's sales are split with about two thirds coming from its in-house products and one third from third party products. In total the company distributes thousands of products and I think it's likely that many of these are commodity products that anybody could make or sell. However, XP is well aware of the dangers of being a commodity supplier and so its whole business model is built around adding value through rapid response manufacturing and distribution, unique product designs, extensive pre- and post-sales technical support for customers and its international reach. So although I'm sure that some portion of its products are commodities, I don't think that's true of the majority.

Indifferent to commodity prices

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

YES Although its products are made of commodity metals and plastics and no doubt some of its customers are affected by large movements in commodity prices, I don't see this as an obvious risk and no mention is made of it in the company's annual reports.

Sound financial policy

17. Does the company have a target rate of return on investment of more than 10%?

NO The company seems to focus on having a high gross margin as its main measure of profitability. Currently gross margins are close to 50%, which are among the highest in the industry. However, I couldn't find any reference to a specific target level of margin.

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

YES XP has almost no debt which gives it a very conservative and safe debt ratio of just 0.5 (my preferred maximum debt ratio for cyclical companies like XP is 4.0).

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

YES Looking at the most recent trading updates from the company and other sources I can see no obvious impending disasters or even minor bumps in the road ahead. This is somewhat unusual for an attractively valued company since popular companies with obviously bright futures are rarely available at bargain prices. So if XP has no obvious problems ahead then why does a company with a double digit growth record have a dividend yield of 3.7% compared to the slower growing FTSE 100's yield of 3.6%? A couple of reasons spring to mind.

First, the company is relatively small. It's in the Small Cap index and has a market capitalisation of just under £350m (which is quite large for a small cap). Small companies are occasionally more obviously mispriced than larger companies because there are fewer investors looking at them than there are looking at, say, BP. So in this example we might say that XP is cheap because there aren't enough smart investors looking at it.

The second reason it might be cheap today is that it's been cheap for many years. For example, it has almost always had an above market dividend yield. So it could be the case that the market has never though much of XP's prospects and therefore investors demand a high yield today because they don't think the dividend is going to grow much tomorrow. In hindsight the market has been wrong because XP's revenues, earnings and dividends have all grown strongly over many years. In fact those investors who purchased the company's shares in 2008/2009 for less than 200p per share and held on have made gains of more than 800%.

Of course the shares are nowhere near that cheap today (sadly), but the market could easily be just as wrong about XP now as it has been for most of the last decade.

Uncovering competitive advantages

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

YES XP designs most of the products it sells, and so it owns those designs. That intellectual property is a form of intangible asset because other companies cannot legally copy those designs, at least for some reasonable period of time. However, I think this is probably a fairly weak form of intangible asset compared to the patents used by pharmaceutical companies, for example. The technology underlying many large pharmaceutical company patents took many millions of pounds and many years to develop. It is then often hugely difficult for competitors to develop alternative medical solutions that are as effective and yet don't infringe upon the patents of other companies. This is probably not the case with power converters where new and better solutions do not typically take many years and hundreds of millions of pounds to develop. So even if intellectual property laws protect XP's in-house designs, competitors can still develop alternative solutions that are functionally equivalent, although it may take them longer and cost them slightly more because one technical route has been cut off.

2. Does the company gain an advantage from "switching costs", i.e. the effort required for customers to switch to a competitor?

YES As with portfolio holdings Senior and to some extent Victrex, many of XP's products are relatively cheap parts of a much more expensive product sold by its customers. For the customer it is worth them spending slightly more on a small item like a power converter in order to guarantee a reliable supply of a high quality product over many years. In these cases there is some stickiness to relationship between supplier and customer because switching to another supplier can take time (which equals money) and can increase risk relative to a known and trusted supplier.

However, not all of XP's business is like this and about a third of revenues are generated through simpler relationships where customers are sold more standard power converters from third party suppliers.

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 Power converters 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)?

NO XP is working hard to keep costs down, first by becoming vertically integrated on order to capture value from the design and manufacturing process as well as distribution, second by opening a low-cost super-efficient plant in China and third by opening an even lower cost, more efficient plant in Vietnam. However, this isn't anything that other companies can't do, so this low-cost advantage is not durable.

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

YES I would be happy to invest in XP for at least the next five years, even if I was barred from selling for the first five years.

XP has been extremely successful at growing through its strategy of vertical integration, internationalisation and targeting blue chip clients. Of course the past is not necessarily an indicator of the future, but I can see no obvious reason why XP cannot continue to grow faster than the average company, as long as the company continues to be well-managed.

Therefore I will be adding XP to the model portfolio and my personal portfolio a few days after this issue is published.

Higher ranked stocks that were not selected	Reason for not selecting
Amec Foster Wheeler, International Personal Finance, Stagecoach, Sepura, Capita, Sky, Essentra	Too much debt
Connect Group	Pension too large
Laura Ashley	10-Yr dividend cover too low; market cap too low