

# SHARES

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A quick way to assess a company's financial strength

## Learn to love the H-score

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**E**very serious investor has one or two horror stories to tell about a company in their portfolio which contrives to go bust. Imagine if there was a tool to help you to quickly and effortlessly identify a company's financial position before you put your cash at risk. Imagine how much money you could potentially save. The good news is there is such an instrument and it is called the H-Score.

No less a figure than the celebrated fund manager Anthony Bolton, who managed the **Fidelity Special Situations** fund from December 1979 to December 2007 delivering a market-beating compound annual return of 20%, writes in his book *Investing Against The Tide* of how he regularly uses the H-Score to warn him of impending trouble at a company.

### Deep impact

The H-score has been developed by Company Watch, a boutique firm located in London, which is partly owned by Atradius, the world's second largest credit insurer.

One of its four founders, chief executive officer (CEO) Denis Baker, tells *Shares* the tool is based on discriminant analysis, a statistical technique first employed in the original 'Z-score' used in the United States since the 1960s: 'We've taken that methodology and turbocharged it, making it broader and deeper. We found that just looking at the sectors doesn't get to the heart of the financial needs of the company. You need to look at the financial structure.'

The H-Score uses information derived from a company's published financial results. It focuses on three main areas and seven individual datapoints:

- **Asset management** covers liquidity, working capital and current asset cover.
- **Funding management** covers the equity base, current funding and debt dependency.
- **Profit management** covers profitability.

It then analyses the data to see how closely it resembles those of companies that subsequently failed. Each firm is given a ranked percentile score, between zero and 100. If a company's H-Score is 25, then only about 25% of the population has characteristics more indicative of failed companies, and the company's health is judged to be weak.

### Warning signs

Companies with an H-Score of zero to 25 are described as being in the 'Warning Area'. Baker takes pains to point out not every company with an H-Score of zero to 25 will go broke even if the H-Scores of the vast majority of failed companies ultimately

come from this range. In June 2010 the recently collapsed Rok was showing a score in the warning zone.

The good news for any company registering a H-score above 25 is Baker estimates it has only a 0.5% risk of failure, although the mechanism is not foolproof as the CEO explains: 'The two things it doesn't take account of are major post-balance sheet events and massive fraud. Also occasionally, if there is a very fast deterioration it may not take account of that.'

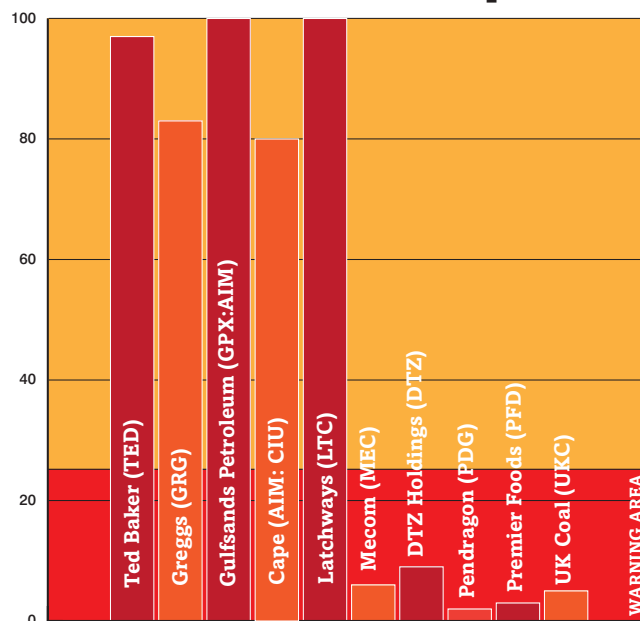
Caveats aside, Baker confirms: 'We do pick up nine out of ten companies that eventually fail. However, only one in four with a H-score below 25 will fail within three years.'

### Access code

Typical clients are institutional fund managers, like Anthony Bolton, for whom Company Watch produces extensive bespoke reports, and analysts who buy database feeds to enable real-time research. 'We typically charge many thousands of pounds for these services', confides Baker. Yet he does provide retail investors with reports on individual companies, albeit for a fee of £30 apiece.

Those market punters worried there may be a ticking time bomb about to rip a hole in their portfolio should at least bear in mind the disciplines the H-score preaches and areas which it analyses, even if they balk at this price. After all, Fidelity's Bolton writes in his book: 'If I had my time again in running my funds and had avoided every share with a bottom-quartile sector H-Score I might have missed a few winners, but I believe I would have avoided most of my disasters.' ■

### H-scores for selected companies



Source: Company Watch