Phil Oakley's Weekly Roundup

Exclusively for SharePad and ShareScope

21 June 2018

Market Overview

Name	Price	%chg 1w	%chg 1m	%chg 1y	1y high	1y low	Date 1y high	Date 1y low
FTSE 100	7556.44	▼-2.7	▼-3.85	▲1.46	7877.45	6888.69	22/5/18	26/3/18
FTSE 250	20729.1	▼-2.79	▼-1.93	▲5.32	21324	19187.1	14/6/18	26/3/18
FTSE SmallCap	5936.15	▼-1.21	▼-1.86	▲5.97	6048.96	5551.56	21/5/18	4/4/18
FTSE AIM 100	5757.14	▼-0.894	▲1	▲18.2	5809.07	4768.33	14/6/18	6/7/17
FTSE All-Share	4164.99	▼-2.66	▼-3.47	▲2.25	4324.41	3810.81	22/5/18	26/3/18
S&P 500	2756.74	▼-0.925	▲0.868	▲13.2	2872.87	2409.75	26/1/18	6/7/17
Brent Oil Spot $	$73.45	▼-3.23	▼-7.52	▲64	$79.68	$44.785	23/5/18	21/6/17
Gold Spot $ per oz	$1267.95	▼-2.65	▼-1.9	▲1.51	$1356.22	$1210.35	24/1/18	7/7/17
GBP/USD - US Dollar per British Pound	1.32518	▼-0.0226	▼-1.34	▲4.55	1.43407	1.26749	16/4/18	21/6/17
GBP/EUR - Euros per British Pound	1.1417	▼-0.384	▲0.219	▲0.59	1.1581	1.0795	16/4/18	29/8/17

Top FTSE All-Share risers

No.	TIDM	Name	%chg 1w
1	MER	Mears Group PLC	▲9.87
2	SFR	Severfield PLC	▲9.62
3	GHG	Georgia Healthcare Group PLC	▲8.94
4	CNCT	Connect Group PLC	▲8.19
5	STHR	SThree PLC	▲7.58
6	DNDL	Dunedin Smaller Companies I...	▲6.94
7	CPI	Capita PLC	▲6.43
8	STVG	STV Group PLC	▲5.9
9	GYM	The Gym Group PLC	▲5.68
10	BBH	BB Healthcare Trust PLC	▲5.53

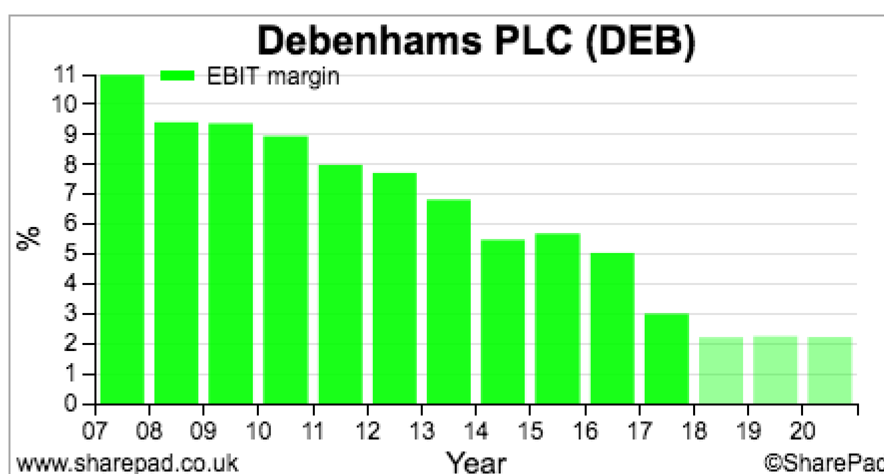
Top FTSE All-Share fallers

No.	TIDM	Name	%chg 1w
1	INDV	Indivior PLC	▼-27
2	MCS	McCarthy & Stone PLC	▼-24.7
3	DEB	Debenhams PLC	▼-17.9
4	FXPO	Ferrexpo PLC	▼-15
5	CWD	Countrywide PLC	▼-14.8
6	KAZ	KAZ Minerals PLC	▼-11.5
7	SMDS	DS Smith PLC	▼-10.5
8	VED	Vedanta Resources PLC	▼-10.3
9	PAY	PayPoint PLC	▼-10
10	BKG	Berkeley Group Holdings (The)...	▼-9.98

Debenhams (LSE:DEB)

Tuesday morning's profit warning from Debenhams was not a big surprise. The torrid trading conditions on Britain's high streets are well known with only a few retailers making a decent fist of things. Betting on falls in retailers' share prices is a very popular investor strategy at the moment. Some might say that they are easy targets for short sellers.

Sentiment towards Debenhams is already very poor as it is the most shorted share on the London stock exchange according to shorttracker.co.uk with 13.4% of its shares out on loan. It's hard to disagree with this sentiment and I think it's perfectly reasonable to question how long this company can stay in business.



Put simply, Debenhams has a business model that seems ill-equipped to cope with modern retailing trends. It is selling fashion and beauty products that are hard to differentiate from the masses of competition out there where items are increasing sold on the basis of price. Price competition and a millstone of high store costs – the company's average store lease length is 18 years – is decimating Debenham's profits.

Despite an attempt to rev up its online business, sales are falling with like-for-like sales falling by 1.7% during the 15 weeks to 16th June. Gross margins are down by 150 basis points as the company has had to cut prices to stay competitive. Given the high fixed cost nature of the business this is blowing a hole in

profitability. Pre-tax profit for 2018 was expected to be just over £50m. The company now expects to make £35-40m.

Net debt levels remain stubbornly high at £320m. When you take into account that the company has an annual rent bill of £220m - equivalent to an estimated off-balance sheet debt of around £1.5bn - then the company finds itself in a difficult position.

Capex is being slashed in order to try and generate some free cash flow whilst the management is also desperately trying to cut costs. This will buy the company some time but it will only delay the day of reckoning in my view.

Debenhams PLC (DEB)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	2,942.8	+26.0%	2,956.4	+0.5%	2,983.6	+0.9%
EBITDA	180.7	+0.7%	183.7	+1.7%	184.7	+0.5%
EBIT	64.8	-7.3%	66.1	+2.0%	65.9	-0.3%
Pre-tax profit	51.7	-12.4%	53.8	+4.0%	53.5	-0.4%
Post-tax profit	42.0	-14.0%	44.8	+6.9%	43.4	-3.2%
EPS (p)	3.4	-15.0%	3.5	+2.9%	3.6	+2.9%
Dividend (p)	1.6	-53.3%	1.5	-6.3%	1.5	0.0%
CAPEX	140.0	+12.2%	141.3	+0.9%	140.9	-0.3%
Free cash flow	2.3	-95.3%	19.2	+747.7%	23.6	+23.1%
Net borrowing	305.3	+10.7%	320.2	+4.9%	324.4	+1.3%
NAV	923.5	+0.6%	935.5	+1.3%	953.5	+1.9%
Like for like sales growth %	-0.9		0.5		1.4	+211.1%

Debenhams is a marginal business with profit margins of barely 2%. This is a terrible position to be in when facing up to a mix of shrinking sales and high debts. A further material fall in profits will see fixed charge cover – the ability of trading profits to cover rent and interest payments – fall to precariously low levels that may test the confidence of suppliers if it isn't doing so already.

At 18.2p per share, the company has a market capitalisation of £223m. If I take pre-tax profits for 2018 to be at the bottom of the new guidance of £35m and assume a 19% tax rate, this gives an estimate for post-tax profits of £28.4m. This would put the shares on a forecast PE of 7.9 times. That might be still too expensive given the outlook for the business.

McCarthy & Stone (LSE:MCS)

You'd think that the market for selling retirement properties should be pretty buoyant. Whilst not all pensioners are wealthy, there are a plenty who are sitting in large houses with lots of equity that could be released by trading down to a smaller property. This should be good news for retirement property developer McCarthy and Stone.

Apparently not, according to the company on Tuesday morning this week. The company announced that there has been a sharp deterioration in trading since it last updated investors in April. Full year completions are now expected to be in the range of 2,100-2,300 compared with 2,302 last year as the company cited ongoing economic uncertainty, a slower secondary market and softer pricing, particularly in the south of England.

Full year operating profits for 2018 were previously expected to be around £105m. They are now expected to be in the range of £65m-£80m (a very big range) due to the weakness in the highly priced south east market.

This is a worrying development for the company in my opinion. The softness in the secondary housing market is a particular concern as this makes it more difficult for its potential customers to sell their homes and raise the funds to buy a retirement property. It should also be noted that McCarthy & Stone had been undertaking more part exchange deals in order to help sales. Selling these assets for good prices and covering their costs could become more difficult.

It seems likely that future profit forecasts will be revised downwards as well as the company has announced a change in focus. This will see growth in building moderate in order to focus on profitability and return on capital employed (ROCE). It will seek to bear down on build cost inflation with the aim of achieving an ROCE in the mid-teens on its developments.

This sounds sensible in theory but the achievement of a specific ROCE is easier said than done as it is largely determined by the selling prices of homes on its land. If selling prices are coming under pressure then an ROCE target can easily be missed.

For me the most interesting comment from the trading update is this:

"McCarthy & Stone will also be trialling a number of strategic initiatives designed to increase customer appeal and offer a broader choice of tenure options including rental and part ownership."

I'm not sure what to make of this. To me it could be interpreted that the company's retirement homes are too expensive and that in order to keep sales volumes high it needs to offer rental and part-ownership options. That said, it should also be considered that this could actually be a very sensible thing to do, providing that acceptable returns can be made from it.

The company's business model is also dependent on charging the buyers of its retirement apartments annual ground rents. These can represent major cash outlays to owners and will put off some potential buyers.

The government is currently looking into this area and there has been some chatter that ground rents could be capped or scrapped entirely. This would improve the attractiveness of retirement apartments in the eyes of buyers but would remove a source of profit for McCarthy and Stone if such legislation was passed by the government.

McCarthy & Stone PLC (MCS)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	749.3	+13.4%	787.6	+5.1%	845.5	+7.3%
EBITDA	107.2	+10.2%	119.4	+11.4%	134.1	+12.3%
EBIT	105.4	+12.4%	117.3	+11.3%	130.1	+10.9%
Pre-tax profit	100.6	+11.1%	112.6	+11.9%	126.7	+12.5%
Post-tax profit	84.6	+15.9%	91.8	+8.5%	101.6	+10.8%
EPS (p)	15.2	+11.8%	17.2	+13.2%	19.4	+12.8%
Dividend (p)	5.5	+1.9%	6.0	+9.1%	6.5	+8.3%
CAPEX	5.0	+354.5%	3.0	-40.0%	3.0	0.0%
Free cash flow	-		-		-	
Net borrowing	-5.9		1.2		-28.5	
NAV	772.0	+3.7%	847.5	+9.8%	916.3	+8.1%

My concern with this company is that the tide looks as if it has turned against it.

Unlike the builders of new homes, there are no Help to Buy schemes to support the purchase of retirement homes or the secondary market which is so crucial to McCarthy & Stone's customers. This means that it is probably going to be harder for the company to sell more homes and explains why its focus is turning towards profitability and ROCE even though this in itself could be difficult to achieve.

The company is guiding to a tangible net asset value of around £700m at the end of August 2018. This equates to 130p per share compared with the 111p at the time of writing. This might suggest that a lot of bad news is already priced into the shares. That said, net asset values are highly geared to changes in the selling prices of homes and these need to be watched closely. The bad news may not be over yet.

Ashtead (LSE:AHT)

Equipment hire company Ashtead has been a great share to own over the last few years. Whilst its fortunes are closely linked to those of the economy in general, and infrastructure spending in particular, it has also benefitted from a shift towards renting rather than owning equipment amongst its customers.

For me, Ashtead is a great example of a company that has been able to grow rapidly by investing money at very attractive rates of return (ROCE). This has come at the expense of its short term free cash flows but the underlying profitability and cash generation of the business has increased.

Ashtead Group PLC (AHT)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	3,657.0	+14.8%	3,968.7	+8.5%	4,272.6	+7.7%
EBITDA	1,748.4	+16.4%	1,924.8	+10.1%	2,087.3	+8.4%
EBIT	1,043.3	+16.6%	1,144.0	+9.6%	1,238.0	+8.2%
Pre-tax profit	935.5	+22.3%	1,032.5	+10.4%	1,143.8	+10.8%
Post-tax profit	642.1	+28.2%	760.3	+18.4%	841.8	+10.7%
EPS (p)	130.8	+30.8%	158.3	+21.0%	177.3	+12.0%
Dividend (p)	33.3	+21.1%	36.8	+10.5%	40.9	+11.1%
CAPEX	1,146.5	+916.4%	1,065.6	-7.1%	1,049.1	-1.5%
Free cash flow	403.8	+29.4%	608.2	+50.6%	783.2	+28.8%
Net borrowing	2,690.1	+6.4%	2,485.5	-7.6%	1,967.9	-20.8%
NAV	2,392.6	+21.4%	2,960.2	+23.7%	3,511.3	+18.6%

The year to April 2018 has been a good one with healthy revenue and profits growth, although pre-tax profits of £927m were slightly lower than the average consensus estimates from City analysts of £935m.

Ashtead makes virtually all its profits in the United States and its business there continues to do very well. It is supported by a commitment to infrastructure spending by the government as well as buoyant industrial markets. Organic revenue growth was a very respectable 15% last year driven by a higher fleet size, unchanged hire rates and slightly higher fleet utilisation.

The company remains confident of being able to invest significant sums of money into the US market for the next three years and delivering high single-digit to low teens rates of revenue and profits growth out to 2021. US profit margins edged up again last year from 30.7% to 31.1%.

Ashtead's UK business saw slightly lower margins due to a change in business mix and higher levels of competition. This and the recently acquired Canadian business led to a slight reduction in overall profit margins to 28% which is still a very good performance. ROCE remains at a very respectable 17%.

One of the key things to check out with any asset rental business is the quality of its profits. In the past these kinds of companies have been known to boost their profits by under depreciating their assets. The way to check for under depreciation is to look for losses when the assets are sold. Losses happen when the cash received from the sale is lower the net book value of it. This happens because the net book value has been under depreciated and sits on the balance sheet for too high a value.

The good news for Ashtead shareholders is that it made profits of just over £20m on asset disposals last year. This was down from the £35.6m made the year before but the overall level of disposals was lower as the age of its fleet increased slightly. The company's depreciation and profit quality therefore look to be absolutely fine at the moment.

Ashtead's cash flow is also looking very healthy. The company presents its operating cash flow differently to many companies. Money spent on new rental assets as well as the interest costs of financing them are included in operating cash flow rather than the investing and financing sections of the cash flow statement. As selling assets is a regular day-to-day activity, I think it is fair that a calculation of Ashtead's free cash flow includes any money raised from it.

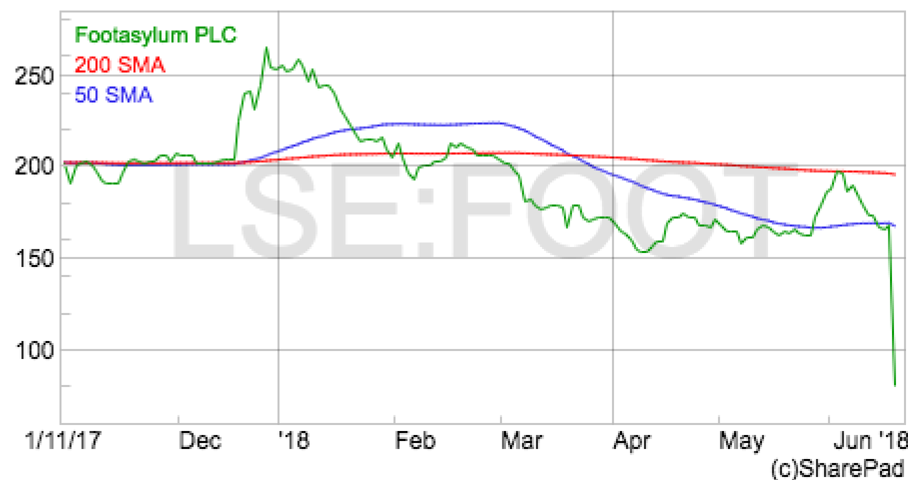
	Audited	
	2018	2017
	GBPm	GBPm
Cash flows from operating activities		
Cash generated from operations before exceptional items and changes in rental equipment	1,681.2	1,444.2
Payments for rental property, plant and equipment	(1,081.7)	(1,021.8)
Proceeds from disposal of rental property, plant and equipment	151.8	153.4
Cash generated from operations	751.3	575.8
Financing costs paid (net)	(110.0)	(101.5)
Exceptional financing costs paid	(25.2)	-
Tax paid (net)	(97.6)	(49.5)
Net cash generated from operating activities	518.5	424.8

This means that Ashtead's net cash flow from operating activities can be interpreted as the free cash flow of the rental business. This has increased by 21% over the last year to £518.5m. This compares with post-tax profits of £632.5m. This shows the good underlying cash generation of Ashtead's business despite net capex (purchases less disposals) being around £250m more than depreciation.

Debt levels have increased when acquisitions are taken into account but net debt to EBITDA has come down slightly from 1.7 times to 1.6 times which is fairly conservative for an equipment rental business.

Whilst Ashtead is in a very healthy position right now, its shares trade on a one year forecast rolling PE of 14.4 times at a share price of 2287p. This doesn't seem to unreasonable given the solid forecast growth rate and taking into account that the business cycle undoubtedly turns down at some point. That said, this is a big premium to its US quoted peer United Rentals Inc which trades on a one year forecast rolling PE of just 10 times but has lower expected levels of growth.

Footasylum (LSE:FOOT)



Footasylum is a fashion retailer that specialises in selling trainers and sportswear to young people in the 16-24 age group. It has 65 stores in the UK and also sells over the internet as well as wholesaling its products. This company listed on AIM last November with some very punchy growth forecasts.

I've no doubt that the investment case for the shares would have been based on a classic retail roll out story. The company's strategy is to grow by opening around eight new stores per year and increasing the size of its existing ones. The target is to get to a store estate size of 150. When this is complemented by a growing online business and wholesaling it's not difficult to see why a stockbroking analyst could write a very persuasive research report on the company.

The trouble is that there is often a gap between theory and reality. Footasylum is trying to grow in a fiercely competitive market that is dominated in the UK by big, established operators such as JD Sports (LSE:JD) and Sports Direct (LSE:SPD). Not only that, but the market for trainers – which account for just over half of Footasylum's sales – is changing as well.

The big beasts of trainers such as Nike and Adidas are increasingly looking to cut out retailers and sell direct to consumers. At the moment, companies such as JD Sports and Sports Direct are big enough to help them shift lots of trainers but whether it stays this way remains to be seen. This is a tough backdrop for a business such as Footasylum which is trying to grab a bigger slice of the market.

As far as its financial results are concerned it seems that all is not well. Revenues increased by 33% last year, helped by the opening of 10 new stores and strong growth in online sales. The problem was that operating profits fell from £8.5m to £8.2m due to higher property and development costs.

Investors quite rightly will be disappointed by this; especially as higher costs are going to weigh on growth in 2019 as well. The company is saying that EBITDA growth will be more modest than in 2018.

What does this mean for proper profits such as operating profit? My view is that the higher depreciation from an increased number of stores could feed through to very disappointing growth and a further fall in profit margins.

Given that the shares were trading on 2019 forecast PE of 26.5 times before the release of its full year results on Tuesday, I was not surprised to see the shares fall sharply afterwards.

I also see a potential red flag in the company's cash flow performance.

	Notes	At 24 February 2018 GBP'000	At 25 February 2017 GBP'000
Cash generated from operating activities			
Profit for the period:	3	161	6,243
Adjustments for:			
Depreciation of property, plant and equipment	3	3,803	2,777
(Gain) / Loss on disposal of tangible assets		(7)	20
Net finance charge		269	311
Share-based payments charge	3	421	-
Taxation charge		1,780	1,897
Increase in stock		(12,199)	(4,447)
Increase in debtors		(3,878)	(1,578)
Increase in creditors		10,727	9,125
Corporation tax paid		(1,787)	(1,517)
Net cash (used in) / generated from operating activities		(710)	12,831

£8.2m of operating profits turned into just over £1m of pre-tax operating cash flow last year. The chief reason for this very disappointing level of cash conversion was a massive increase in stock which led to a £12.2m cash outflow. The closing level of stock on the balance sheet was 51.9% higher than a year ago compared with a 33% growth in revenues.

There can be legitimate reasons for this, especially for a business that is opening new stores as you have to have stock to sell before you open the doors. That said, I never really like to see stocks increase considerably faster than revenues in a retailing business as it does raise questions as to whether it is experiencing soft trading that might require the discounting of that stock – and a hit to profits – in the future.

Time will tell.

Footasylum PLC (FOOT)

FORECASTS £ millions unless stated

Year	2018		2019		2020	
Turnover	183.3	+24.7%	230.5	+25.8%	282.1	+22.4%
EBITDA	12.4	+10.0%	15.1	+21.9%	18.9	+25.2%
EBIT	8.6	+2.3%	9.7	+12.7%	12.1	+24.7%
Pre-tax profit	-		-		-	
Post-tax profit	-		-		-	
EPS (p)	5.5	-8.3%	6.3	+14.5%	8.0	+27.0%
Dividend (p)	-		-		-	
CAPEX	-		-		-	
Free cash flow	-5.1		-3.5		-0.9	
Net borrowing	-8.6		-5.1		-4.2	

Current consensus forecasts will clearly be revised downwards. That said, I think there are more important things to consider about this company. To me, it is by no means certain that it has a strong enough business model to make acceptable returns on capital in the long-run.

I estimate that the company had just over £100m of lease debt at the end of February 2018 and lease adjusted capital employed of around £150m. With lease-adjusted operating profits of around £15m (around £7m of lease interest is added to underlying operating profits but you can take your own view on what the right number should be) this gives a lease-adjusted ROCE of 10% at current levels of profitability. That isn't a terrible number, but it could deteriorate as more capital is invested in the business and margins trend lower.

Having warned on profits so soon after listing, the company will have suffered some loss of credibility with investors. It has a hard job to convince them that its business is a long-term winner in my opinion.

Telecom Plus (LSE:TEP)

Telecom Plus trades under the Utility Warehouse brand. It sells utility services – gas, electricity, home phone, broadband and mobile phone – to people and businesses via a network of 40,000 self-employed distributors or partners.

The company's customer proposition is based on simplicity – all your utility services on one monthly bill – and saving money – the more services you take, the more money you save.

I think having one monthly bill for utilities is a great idea and one that will appeal to a lot of people. My problem with this business is that I've never been convinced that I could really save money for the same level of service I already have.

I had quite a close look at the operational side of the business a few years ago. A friend of mine is a distributor and is also involved with the sales training of his peers. I've been along to a seminar and spent a lot of time talking to him about the company. He is earning a decent living from his sales commissions (a percentage of his customers' monthly bill) and has done very well from being a long-term owner of Telecom Plus shares.

The point is, he's never been able to convince me to switch. I believe that I can get better energy, broadband and mobile deals myself. I might be able to get a cheaper broadband or mobile phone package from Utility Warehouse but I find that I'll have slower download speeds or lower monthly data allowances in return.

A few years ago, the company was doing very well. It was gaining plenty of new customers and selling more products. Its share price reflected that progress and baked in hopes that it could keep on growing.

Unfortunately, the company is having a hard time wooing more customers and growing its profits. Last year, pre-tax profits increased by just 1.8% to £54.3m.

	2018	2017
Electricity	555,721	551,622
Gas	449,810	446,394
Fixed Telephony (calls and NGN)	321,494	320,269
Fixed Telephony (line rental)	307,742	303,787
Broadband	283,518	276,721
Mobile	221,716	201,372
CashBack card	195,960	188,753
Home Insurance	4,758	-
Total	2,340,719	2,288,918
Residential Club	2,261,680	2,205,462
Business Club	79,039	83,456
Total	2,340,719	2,288,918

Despite offering utilities and recently home insurance, Telecom Plus remains heavily reliant on electricity and gas revenues. Together, these make up nearly 80% of its total revenues but only 43% of the total number of services it provides.

Revenues GBPm	2018	2017
Electricity	337.5	310.4
Gas	280.3	265.8
Landline and Broadband	114.0	106.7
Mobile	30.8	27.5
Other	13.5	12.4
	776.1	722.8

For many existing and potential customers, it is the cost of their monthly electricity and gas bill that plays a big part in the decision as to whether they stay with or switch to Utility Warehouse. This market is very hard going at the moment.

Telecom Plus has a gas and electricity supply deal with Npower that allows them to offer cheaper tariffs than the big six energy suppliers. However, the competition is coming from small, independent suppliers offering very low prices and incurring big losses to woo customers. As a result, this has made it difficult for Utility Warehouse to grow its customer base. Last year, residential customer numbers increased by around 4,500 to just over 583,000. The number of services taken by customers increased, with mobile seeing some decent growth.

For me, I've always thought that the biggest attraction of Utility Warehouse is its cashback card. It gives 3-9% cash back at a selection of prominent retailers and 1% everywhere else. The payments are reflected in a reduction in your monthly utility bill. I'm not that convinced now.

How much can you really expect to save? If you do your weekly grocery shopping at Sainsbury's and get 3% cash back then I can see how there could be a reasonable saving to be made off your bill. But you might be able to actually save more money by shopping at Asda or Morrisons instead where your bill would probably be more than 3% cheaper.

I might be wrong but I don't see the other cashback partners - such as restaurants and clothes shops – as places where people would regularly spend enough money to get a meaningful reduction in their monthly utility bill.

The other problem with the cashback card is that it is not a debit or a credit card. You have to load it up with money before you buy things with it. This will undoubtedly put people off having one which may explain why only around a third of Utility Warehouse's residential customers have one.

Telecom plus PLC (TEP)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	781.6	+5.6%	824.1	+5.4%	885.0	+7.4%
EBITDA	58.2	+1.1%	62.9	+8.0%	70.7	+12.6%
EBIT	54.6	+29.1%	60.2	+10.4%	66.2	+10.0%
Pre-tax profit	54.0	+32.1%	57.5	+6.5%	62.1	+8.0%
Post-tax profit	45.7	+50.3%	51.0	+11.5%	55.4	+8.7%
EPS (p)	56.6	+49.7%	62.5	+10.4%	70.8	+13.3%
Dividend (p)	50.2	+4.6%	52.7	+5.0%	56.6	+7.4%
CAPEX	3.0	-45.2%	3.0	0.0%	3.0	0.0%
Free cash flow	44.0	+20.0%	49.0	+11.4%	54.0	+10.2%
Net borrowing	5.2		2.1	-59.3%	-9.8	

Telecom Plus is not a bad business, I'm just not convinced it can grow much in the future. It will keep on adding new services such as insurance but I think it will continue to find it hard to really scale its business in the face of intense competition.

The company is guiding 2019 pre-tax profit forecasts in the £55m-£60m range which means that current consensus forecasts look about right. It remains a very shareholder-friendly business and has said that it expects to pay a dividend of at least 52p per share for 2019.

At a share price of 1060p, the prospective dividend yield of 4.9% remains the main attraction but is based on paying out virtually all the company's profits. Dividend cover is therefore very thin and increases the risk of a dividend cut if profits fall.

Berkeley Group (LSE:BKG)

I don't personally invest in the shares of housebuilders. This is because I don't believe that they are capable of delivering the resilient and steady profits growth that I look for. Profitability is highly dependent on the general level of house prices which have shown a regular tendency to move from a state of boom to bust over the last 50 years.

However, if you were to ask me to name one builder that I would rate above all others it would be Berkeley Group. The business has been run by Tony Pidgley for years and he has developed an impressive reputation for managing it over the ups and downs of the housing cycle. He is also very open and candid with investors on the general health of the housing market.

Its strategy has seen it buy land when times are bad and it is cheap and sell when times are good and it is expensive. The business has been almost exclusively focused on London and the south east. It has served shareholders very well. The company's shares have doubled since the last housing market peak in 2007.

Only Bellway (LSE:BWY) amongst its peers has managed to match that achievement.

The effectiveness of Berkeley's business model is highlighted in this week's full year results. For the last few years, the company has been selling houses on land it bought between 2010 and 2013 when prices were cheap. The rise in prices seen since 2013 has allowed this land to deliver phenomenal returns on the money invested in it.

Berkeley sold 9% fewer homes last year, but a 5.9% increase in average selling prices offset build cost inflation of 4-5% and allowed gross margins to nudge up from 34.5% to 35%. A strong performance from its joint ventures of high value central London properties saw pre-tax profit increase by 15.1% to £934.9m.

This represented a pre-tax return on shareholders' equity of a staggering 39.3%, down from 41% last year. Given that Berkeley has very little sales that use Help to Buy, this is an even more impressive result.

The bad news for shareholders is that these sensational returns will not last and that profits have peaked. It seems that Berkeley has used up all its supply of cheap land and will now be building on more expensive sites. This means that profits are expected to be 30% lower in 2019 with the company targeting average pre-tax returns on equity of 20% over a housing market cycle (however long that might be).

The company is still trying to keep shareholders happy by paying out large special dividend payments and spending money buying back shares. A further £6 per share is due to be returned to shareholders by 2021 on top of the more than £10 per share that has already been paid out.

That said, there's no doubt that it is getting harder for builders to make good money. The London market is incredibly expensive relative to wages and remains significantly propped up by investors – many of them foreign – which account for half of Berkeley's sales. This level of support remains vulnerable to changing economic conditions and London's status as an attractive place to invest money but remains reasonably well underpinned by a chronic shortage of housing in the capital and the demand for renting there.

I think 2019 numbers look pretty safe with £2.2bn of forward sales at prices at or above those assumed in the company's business plans. Beyond that it is harder to call, although analysts are currently predicting a further fall in profits in 2020 which seems reasonably given the rising cost of the company's housing plots.

Berkeley Group Holdings (The) PLC (BKG)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	2,738.7	+0.6%	2,508.7	-8.4%	2,349.2	-6.4%
EBITDA	798.1	-2.6%	628.5	-21.2%	549.6	-12.6%
EBIT	795.1	-2.6%	626.2	-21.2%	552.6	-11.8%
Pre-tax profit	905.6	+11.5%	629.4	-30.5%	579.7	-7.9%
Post-tax profit	734.7	+13.9%	510.2	-30.6%	473.5	-7.2%
EPS (p)	521.4	+15.5%	360.9	-30.8%	334.3	-7.4%
Dividend (p)	172.2	+25.7%	204.7	+18.9%	201.0	-1.8%
CAPEX	4.3	+52.1%	3.6	-16.0%	3.5	-2.2%
Free cash flow	694.1	+42.3%	398.1	-42.7%	340.5	-14.5%
Net borrowing	-624.3		-759.7		-838.1	
NAV	2,603.7	+21.8%	2,867.0	+10.1%	3,092.4	+7.9%

The company retains a very healthy landbank with 32,921 owned plots and a further 13,946 under contract without planning permission. It also has another 5,000 plots of strategic land. The land has a potential gross profit of £6bn based on the company's current assumptions regarding selling prices, build rates and build cost inflation.

Berkeley's shares have been a great long-term investment but have struggled so far in 2018. At 3910p they trade at just about twice the net asset value per share of 1959p. If you believe that the company can make average returns on equity of around 20% going forward and you require a 10% annual return from owning Berkeley shares them it suggests that the current share price is about right.

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