investors CHRONICLE alpha

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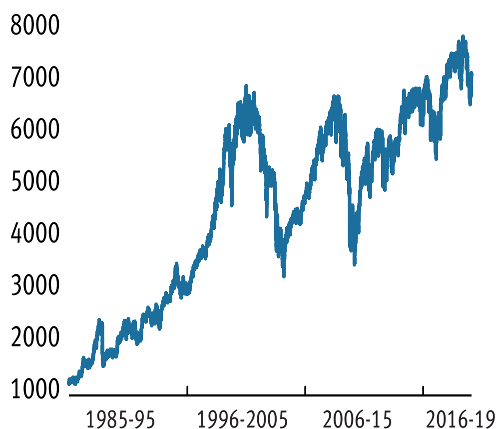
Phil Oakley's Weekly Round-Up

Trying to time cycles is a perilous task and many economists and market experts get it wrong. Rather than try and spot peaks and troughs, it is far better to focus on finding shares in quality companies that aren't too expensive

FTSE 100 is hard to time



Source: Bloomberg

Alpha Editor: James Norrington

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The companies mentioned this week are:
- Barratt Developments
- Redrow
- Ryanair
- Carpetright
- Compass Group
- Bellway

What's the point of economists and market experts?
You might think that the title above is a strange one for me to write, especially as I earn my living writing for a magazine that comments on the world of investing and finance.

I am passionate about the whole process of saving and investing and like analysing and writing about companies and their shares. Unsurprisingly, I do think and hope that someone like me has something to add to help readers become better investors.

When it comes to trying to predict the future direction of economies and stock markets, I am less convinced. I just think that it is virtually impossible to predict what direction they will take with any kind of accuracy that will be of any use to an investor to base their decisions on.

This doesn't mean that lots of people won't keep on telling us that they can predict the future. Yet, economists have a very poor track record in forecasting turning points. The reputation of economics as a subject also remains highly discredited and was exposed for its failings in the last recession.

Markets do give us some useful pointers such as valuation data. Starting valuations can be a good predictor of future returns from shares and bonds. This does give stock market commentators some kind of basis to give an

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opinion worth listening to at the very least.

However, if you are reading this, you will be more interested on focusing on individual companies rather than markets. This is unquestionably the right thing to do in my opinion.

A lot of successful investing is about getting the basics right and not overcomplicating things. To succeed you have to spend less than you earn, and reinvest your savings into investments that will give you returns higher than the rate of inflation and increase the buying power of your money.

This requires diligence,hard work and an amount of luck. But for long-term investors in individual shares it has always been identifying good companies at attractive prices and staying away from bad and expensive ones. This is what I will continue to write about.

Barratt Developments

Half-year results released by Britain's biggest housebuilder, **Barratt Developments (BDEV)** on Wednesday show that the company continues to trade well and remains in very rude health.

The company's revenues grew by 7.2 per cent and were achieved entirely by selling more homes, rather than relying on average selling prices (ASP) increasing. In fact, ASPs barely budged at all and actually fell. The falls are entirely due to a change in the selling mix, with Barratt focusing on more two and three bedroom homes, rather than a sign of housing market weakness.

A key strength of Barratt's business model in recent years has been its ability to buy land at good prices and increase profit margins from it. It has also made good use of strategic land – land that was bought without planning permission for cheaper prices – to help it do this. Twenty six per cent of its homes sold during the first half of its financial year came from strategic land plots.

Gross profit margins increased from 20 per cent to 22 per cent, with operating margins up from 17.9 per cent to 19.2 per cent, which fed through to a 19 per cent increase in pre-tax profits. The company looks well set to meet current full-year profit forecasts.

Our land bank	31 December 2018	31 December 2017
Owned and unconditional land bank (plots)	63,125	64,542
Conditionally contracted land bank (plots)	17,505	19,075
Total owned and controlled land bank (plots)	**80,630**	**83,617**
Number of years' supply	**4.7**	**5.0**
JVs owned and controlled land bank (plots)	5,426	5,329
Strategic land (acres)	12,192	11,806
Land bank carrying value	£2,994.4m	£3,229.0m

Source: Company report

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Based on the current market conditions and continued government support for the housebuilding sector until 2023 – via the Help to Buy scheme – Barratt's land bank looks well placed to maintain its current profit margins and returns on capital at the very least. It is running a relatively short land bank of 3.7 years based on its own land to keep capital invested relatively low and improve return on capital employed (ROCE). With an average selling price on that land of £276,000 it expects to maintain gross margins at their current level.

Costs remain a concern with build cost inflation currently running at 3-4 per cent. Barratt is trying to offset this by rationalising and simplifying its house designs. It is using more timber frames, large format blocks and light gauge steel frames that can utilise modern construction techniques. This, in turn, allows homes to be built faster and with reduced labour costs.

Barratt Developments PLC (BDEV)

FORECASTS £ millions unless stated

Year	2019		2020		2021	
Turnover	4,933.9	+1.2%	4,965.7	+0.6%	5,159.6	+3.9%
EBITDA	894.4	+0.9%	915.7	+2.4%	982.5	+7.3%
EBIT	893.5	+1.4%	916.1	+2.5%	976.9	+6.6%
Pre-tax profit	859.9	+3.0%	875.6	+1.8%	921.2	+5.2%
Post-tax profit	697.8	+4.0%	713.3	+2.2%	759.3	+6.4%
EPS (p)	68.3	+3.8%	69.9	+2.3%	74.3	+6.3%
Dividend (p)	44.9	+69.4%	46.6	+3.8%	49.2	+5.6%
CAPEX	9.0	+20.6%	9.8	+8.7%	9.0	-8.8%
Free cash flow	516.5	-6.1%	569.4	+10.2%	654.8	+15.0%
Net borrowing	-757.1		-933.8		-1,069.9	
NAV	4,228.0	-7.9%	4,760.0	+12.6%	5,299.0	+11.3%

Source: SharePad

Barratt's finances remain in good shape with net cash balances at the end of December 2018 more than double what they were a year ago, at £387.7m. This is entirely due to the timing of land payments, with the company buying fewer plots (9,576 vs 13,263) and spending £300m less than it did in the first half of last year. It intends to buy 18,000-22,000 new plots for the year to June, with year-end net cash expected to be £600-£650m – lower than current market forecasts.

Barratt has been quite candid about its cash position throughout the year: "We maintain a modest average net cash position over the financial year and are cash-positive at the year-end."

Yet Barratt keeps its balance sheet net cash position high by buying land on credit. The company has nearly £1bn of land creditors that are not counted as debt, but there is an imputed interest charge on them in its income statement. Counting land creditors as debt would also increase the company's effective capital invested and reduce its ROCE.

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I always count cash as capital employed and do not net it off as many people do. Adding back land creditors and ignoring cash increases Barratt's capital employed significantly and reduces its ROCE to around 19 per cent, excluding goodwill, according to my calculations – which is still a good number – but is lower than the 29 per cent claimed by the company.

Barratt's shares trade on 1.6 times its tangible net asset value per share, at a share price of 565p, and offer a prospective dividend yield of over 8 per cent on a rolling basis, which includes the benefit of special dividends. This looks reasonably attractive.

The trouble is that history tells us housing markets and the profits of builders move up and down together. The valuation of Barratt's shares is already pricing in the view that profits will fall at some point, but the large income returns from the shares look safe for now.

Redrow

Over at rival **Redrow (RDW)**, it seems there isn't as much confidence about the future outlook. During the first half of its 2018-19 financial year it sold 12 per cent more homes, but operating profits increased due to changes in the selling mix.

Sales of its core Heritage private brand performed well, with volumes up by 8 per cent and average selling prices up by 6.6 per cent. Shareholders are being rewarded with an 11 per cent increase in the interim dividend and a 30p per share return of capital by way of a B share issue.

Redrow private sales

	Turnover (£m)			Volume			ASP		
	H1 19	H1 18	Var	H1 19	H1 18	Var	H1 19	H1 18	Var
Heritage	674	586	88	1,732	1,604	128	389	365	24
Bespoke	173	230	(57)	432	570	(138)	400	404	(4)
Private Total	847	816	31	2,164	2,174	(10)	391	375	16

Source: Company report

Where things start to get a little cloudier is in the signs Redrow might be giving about the future. If we look at its land bank then it is not adding to it. This may be for a very good reason, in that it already feels that it has enough and does not want to tie up more capital, which is very plausible and sensible. The other possibilities are that Redrow cannot buy land at attractive prices or is not as confident in the health of its markets.

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Redrow movement in land bank

	Total Plots
At 1 July 2018	30,700
Additions	1,721
Transfers to current land	(1,217)
Strategic review	(704)
At 31 December 2018	30,500

Analysis		Dec 18	Jun 18
Land owned without planning		3,131	2,973
Land contracted without planning		1,937	2,722
Options	- allocations	11,862	12,257
	- realistic prospect	13,570	12,748
		30,500	30,700

Source: Company report

I may be guilty of looking for a problem where there isn't one, but Redrow's trading performance does look a bit more subdued than some of its peers.

Redrow reservations

The company does have a significant exposure to the south of England and London (53 per cent of revenues in H1) where the market has become tougher, and big family properties are priced at close to or above the Help to Buy threshold of £600,000, which makes them harder to sell.

Its closing private order book was lower at the end of December 2018 and during the first five weeks of 2019. Strength in affordable housing orders means the total order book is 11 per cent higher.

H1	2019	2018
Value of private net reservations (£m)	795	795
Private reservations per outlet per week	0.61	0.64
Closing private order book (£m)	840	894
Closing total order book (£m)	1,162	1,047
Cancellation rate (%)	16	15

H2 (first 5 weeks)	2019	2018
Value of private net reservations (£m)	156	166
Reservations per outlet per week	0.65	0.71

Source: Company report

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I think June 2019 pre-tax profits forecasts look achievable at the moment. The trailing 12-month pre-tax profit of £389m to December 2018 compares with a current forecast of £403m, but the company cannot afford any more weakness in private reservations, in my opinion.

Redrow PLC (RDW)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	2,063.4	+7.5%	2,127.3	+3.1%	2,255.5	+6.0%
EBITDA	411.3	+4.7%	409.0	-0.6%	428.5	+4.8%
EBIT	394.6	+1.2%	406.3	+3.0%	427.1	+5.1%
Pre-tax profit	403.1	+6.1%	392.7	-2.6%	400.9	+2.1%
Post-tax profit	329.5	+7.0%	319.2	-3.1%	336.7	+5.5%
EPS (p)	90.1	+5.8%	95.5	+6.0%	100.6	+5.3%
Dividend (p)	29.8	+6.4%	31.9	+7.0%	33.9	+6.3%
CAPEX	2.9	+44.5%	2.8	-1.6%	2.9	+0.2%
Free cash flow	147.1	-25.0%	213.4	+45.1%	244.0	+14.4%
Net borrowing	-128.7		-203.3		-355.7	

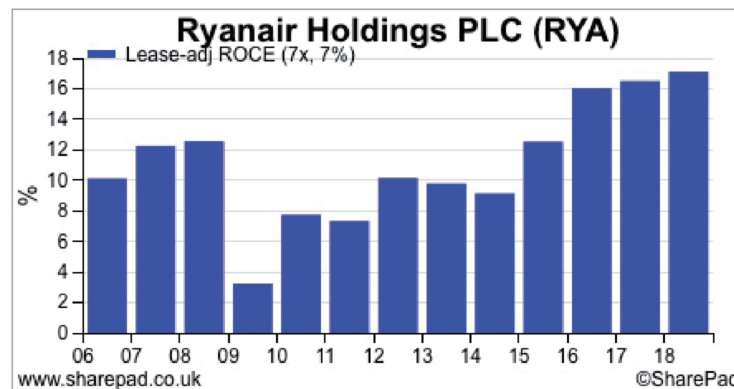
Source: SharePad

At 595p, Redrow's shares are slightly cheaper than Barratt's, trading on 1.4 times its latest net tangible assets per share. I'd probably feel happier owning Barratt shares though, as current trading at Redrow would make me a little bit nervous.

Ryanair

Ryanair (RYA) is Europe's biggest airline and is expected to carry 142m passengers in the year to March 2019. It has done this by being the lowest cost operator, which allows it to offer the cheapest fair that its competitors cannot match without losing money. This is Ryanair's economic moat in an industry that is very good at losing money.

In recent times, Ryanair has been able to make highly respectable profit margins and returns on capital. Last year, its profit margin was 23.4 per cent and its ROCE (including rented aircraft) was a very respectable 17 per cent. Those are the hallmarks of a very good business from a shareholder's point of view.



Source: SharePad

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Ryanair's staff and passengers sometimes take a different view. The company has been in dispute with its pilots and cabin crews and does not have the best reputation for customer service. This seems to be all water off a duck's back as far as the company is concerned, which seems to give the impression that all publicity is good publicity.

Ryanair's low fares ensure that virtually every seat on its planes is occupied, but it hasn't been able to protect itself from a very difficult European market where there are too many planes chasing too few passengers.

The tough market has shown itself in Ryanair's recent third-quarter results.

	Dec 17	Dec 18	
Guests (m)	30.4	32.7	+8%
Avg. fare (incl. bag)	€32	€30	-6%
Ancills per guest	€14	€17	+18%
Rev per guest	€46	€47	+1%
Unit costs (ex fuel)	€28	€30	+6%
Profit/(Loss)* (m)	€106	(€20)	

Source: Company report

Despite flying more passengers with planes that were 96 per cent full and getting them to spend more money on top (ancillary revenues), the company lost money. Unit costs were 6 per cent higher due to a big increase in pay for pilots and the costs of staff shortages. Fuel costs were 32 per cent higher year on year and will be higher again next year, as 90 per cent of fuel requirements are hedged at a price that is 22 per cent higher than this year.

Airlines' profits remain very sensitive to the fares charged. Third-quarter (Q3) fares were down by 6 per cent and could fall by 8 per cent in Q4. This is going to feed through to annual pre-tax profits of around €1bn, compared with €1.6bn last year. Weaker competitors will not survive the current bloodbath, but it looks as if it could be a while before fares can start rising again.

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Ryanair Holdings PLC (RYA)

FORECASTS — € millions unless stated

Year	2019		2020		2021	
Turnover	7,647.6	+6.9%	8,542.0	+11.7%	9,280.1	+8.6%
EBITDA	1,831.5	-18.0%	1,995.8	+9.0%	2,268.2	+13.6%
EBIT	1,195.2	-28.5%	1,317.8	+10.3%	1,537.7	+16.7%
Pre-tax profit	1,134.1	-29.6%	1,240.3	+9.4%	1,458.1	+17.6%
Post-tax profit	1,039.4	-28.3%	1,112.4	+7.0%	1,318.6	+18.5%
EPS (¢)	87.7	-27.2%	90.7	+3.4%	110.3	+21.6%
Dividend (¢)	15.7		-		9.3	
CAPEX	1,497.6	+1.8%	1,650.4	+10.2%	1,645.7	-0.3%
Free cash flow	219.6	-71.2%	333.9	+52.1%	661.5	+98.1%
Net borrowing	788.2	-67.8%	590.7	-25.1%	158.0	-73.3%

Source: SharePad

I've never viewed airline stocks as buy and hold investments. They are essentially trading stocks and you are buying them when profits are heading upwards. I look at current analysts' forecasts and take them with a very liberal pinch of salt. Ryanair is cautious on fares for summer 2019 and this has to be a source of downside forecast risk.

Longer term, the company has a goal to carry 200m passengers a year by 2024. The recent acquisition of Laudamotion in Austria will give it a helping hand. Ryanair is betting big on an order of 135 – with an option for a further 75 – Boeing 737-Max 200 aircraft to further drive down unit costs and then offer lower fares to further increase its competitive advantage.

New planes will account for 10 per cent of Ryanair's fleet by 2020. They have 4 per cent more seats and are 20 per cent more cost-effective per seat than existing 737s. Whether these preserve or grow profits remains to be seen.

Carpetright

One look at **Carpetright's (CPR)** share price chart would make most people ask: how long before this company goes bankrupt? Yet, at a share price of just 20p, the market capitalisation of this company is still £61m. The company was lossmaking last year and is expected to be so again this year. How long can it survive before it runs out of cash?

The company raised £62m of new equity in June last year and is looking to save £19m of costs from the business. It has closed stores and reduced the average length of the leases on its stores to 3.5 years. All this helps, but if like-for-like sales keep falling then its difficult to make a profit when you are already losing money.

Retaining the confidence of suppliers is key for this company, as credit insurance is often refused when supplying struggling retailers.

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Carpetright PLC (CPR)

FORECASTS £ millions unless stated

Year	2019		2020		2021	
Turnover	386.7	-12.9%	383.4	-0.9%	394.0	+2.8%
EBITDA	2.8	-56.9%	22.3	+710.8%	30.0	+34.3%
EBIT	-		-		-	
Pre-tax profit	-17.2		5.0		-	
Post-tax profit	-		-		-	
EPS (p)	-4.9		-		4.3	
Dividend (p)	-		-		-	
CAPEX	-		-		-	
Free cash flow	-		-		-	
Net borrowing	23.0	-56.6%	-		-	

Source: SharePad

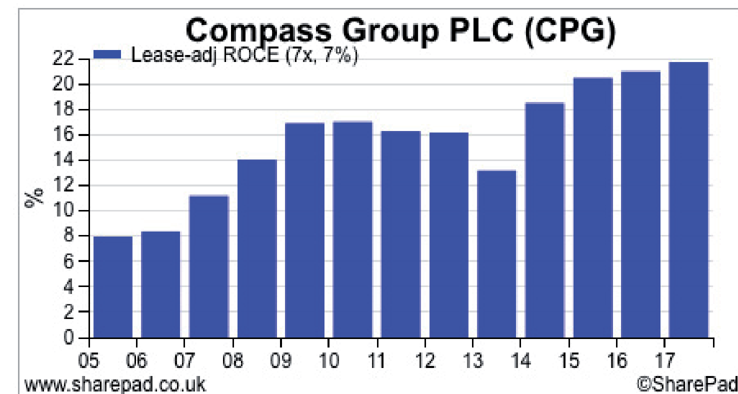
Competition remains intense and the housing market seems to be softening (Carpetright's sales are helped by people moving home). It is difficult for me to see how this company can turn itself around. Even brave, contrarian investors do not need to own this share.

Compass Group

Compass (CPG) makes money by running workplace canteens and food service in schools, hospitals and government locations, as well as providing vending machine services. It also provides other services such as cleaning, housekeeping and maintenance. It is the largest contract caterer in the world with £23bn of annual revenues. Over half its revenues come from North America.

Compass was one of the first companies I ever looked at as at an analyst over 20 years' ago. I have to admit that at the time I didn't like it too much. It seemed too reliant on acquisitions, had very low profit margins and its ROCE was not much higher than what people could earn on gilts at the time (circa 7 per cent).

My initial scepticism has proven to be misplaced over the long run, as Compass has kept on growing organically and has become a much better business. and is now earning the kind of ROCE that suggests it is a very good business.



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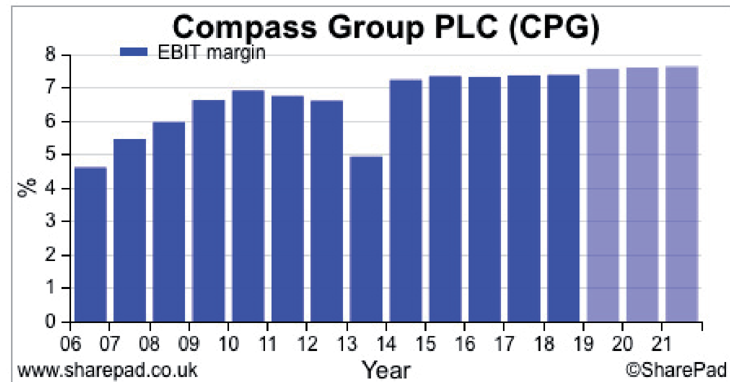
Profit margins remain on the lowish side, but have been reasonably consistent apart from a blip in 2013. This is a company that makes its ROCE by selling more on the money it invests (its capital turnover).



Source: SharePad

Despite growing strongly over the years, both organically and by acquisitions, Compass is still bullish about its ability to win and retain more business from corporate customers.

Its first-quarter trading update for the three months to December 2018 has seen organic sales increase by 6.9 per cent, with 8 per cent growth in America. This is ahead of its 4-6 per cent sales growth target. Margins are nudging up as well, which is encouraging.

The company looks on course to meet current profit forecasts for the year to September 2019 and upgrades are possible if the strong sales momentum continues.

I quite like the look of shares in Compass as an investment to tuck away for the long term and let them compound in value.

Compass Group PLC (CPG)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	24,788.2	+7.9%	26,017.9	+5.0%	27,433.8	+5.4%
EBITDA	2,399.1	+7.1%	2,531.9	+5.5%	2,709.5	+7.0%
EBIT	1,876.1	+10.7%	1,979.4	+5.5%	2,093.9	+5.8%
Pre-tax profit	1,753.5	+10.9%	1,858.1	+6.0%	1,971.6	+6.1%
Post-tax profit	1,335.4	+18.7%	1,411.1	+5.7%	1,501.4	+6.4%
EPS (p)	84.2	+8.5%	90.1	+7.0%	96.7	+7.3%
Dividend (p)	40.7	+8.0%	45.3	+11.3%	46.7	+3.1%
CAPEX	808.1	-0.4%	823.5	+1.9%	881.6	+7.1%
Free cash flow	1,107.6	+1.2%	1,214.7	+9.7%	1,282.8	+5.6%
Net borrowing	3,208.2	-7.1%	2,899.3	-9.6%	2,767.5	-4.5%
NAV	2,978.5	+13.9%	3,741.0	+25.6%	4,038.0	+7.9%

Source: SharePad

As with many quality companies, its shares come with a reasonably high valuation attached. At 1,696p, they are on a one-year forecast rolling PE of 19.7 times. That does not look excessive compared with other quality large-caps such as Unilever or Diageo. The shares look worthy of further research.

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Bellway

Bellway's (BWY) half-year trading update released on Thursday shows that the company is trading well. Sales are up by 12 per cent, with volumes growing by a healthy 5.6 per cent and average selling prices increasing by 6.5 per cent to £293,000.

This first-half performance suggests that the company is comfortably on course to meet full-year forecasts, but there are comments within the trading statement which suggest that the end markets are softening. Bellway, like Redrow, seems to be taking a cautious approach.

Bellway's reservation rates are at an all time high, driven by sales of affordable housing rather than private homes where the reservation rate is unchanged. Cancellation rates have also increased from 11 per cent to 13 per cent, which is below Redrow's 16 per cent, but again is a sign of a softer market.

Profit margins may have peaked. Half-year margins are expected to be 21.5 per cent against 22.2 per cent achieved last year. Many builders have seen rising margins over the past few years, as higher selling prices have leveraged the cost of land bought cheaply or written down in value during the last recession. That effect now seems to have worn off.

Bellway PLC (BWY)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	3,095.2	+4.7%	3,203.2	+3.5%	3,385.0	+5.7%
EBITDA	671.3	+2.2%	685.2	+2.1%	718.2	+4.8%
EBIT	669.4	+2.1%	684.9	+2.3%	712.7	+4.1%
Pre-tax profit	659.7	+2.9%	678.7	+2.9%	704.9	+3.9%
Post-tax profit	533.1	+2.5%	549.3	+3.0%	565.8	+3.0%
EPS (p)	435.7	+3.3%	452.4	+3.8%	472.0	+4.3%
Dividend (p)	147.4	+3.1%	160.5	+8.9%	171.4	+6.8%
CAPEX	3.5	-11.1%	3.5	-0.8%	3.2	-6.5%
Free cash flow	309.1	+23.5%	387.4	+25.3%	246.1	-36.5%
Net borrowing	-237.2		-420.8		-609.3	
NAV	2,920.0	+14.2%	3,308.0	+13.3%	3,717.0	+12.4%

Source: SharePad

Another note of caution is that the forward order book in terms of units and value is below last year's. This was also the case with Redrow. Is this because buyers are holding off and awaiting the outcome of Brexit or is it because house price affordability is now so stretched, relative to people's take home pay, that it is getting more difficult to sell houses at higher prices?

As with its peers, a lot of caution now seems to be factored into Bellway's share price. At 2,856p, the shares trade on 1.2 times forecast net tangible asset value and offer a dividend yield of 5 per cent.

I'm not a fan of housebuilders generally because I feel

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that Help to Buy has distorted the new-build market and inflated the view of what is their sustainable level of profits. Despite this, I am beginning to feel that the pessimism being baked into share prices might make them an attractive short-term trade, despite the risks of political shocks in the next few weeks.

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