investors CHRONICLE alpha

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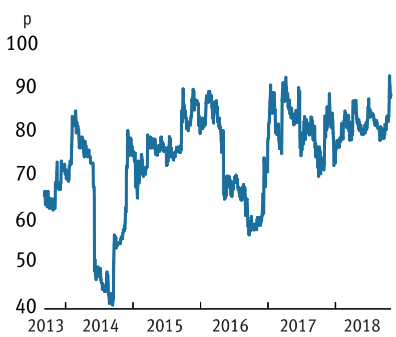
TClarke: Profit from a buoyant earnings cycle

The record order book of the building services group is highly supportive of a step change in profits, while free cash-flow generation underpins a progressive and very healthy dividend, factors that a forward PE ratio of 5.5 fail to reflect

TClarke (CTO)

Ticker	CTO
Current price (p)	90
Target price (p)	141
Market cap (£m)	38.3
52-week high (p)	93.6
52-week low (p)	68.2
Net cash (£m)	4.6 (reported at 30 Jun 2018)
Shares in issue (m)	42.5
Financial year-end	31 Dec
Next event	2018 full-year pre-close trading update on 31 January 2019
Company website	tclarke.co.uk

TClarke share price



Source: Bloomberg

Simon Thompson's view:

Investors have yet to wake up to the buoyant trading building services company **TClarke (CTO)** is enjoying, nor for that matter the record order book that underpins expectations of double-digit earnings growth in the coming years. And with cash building strongly, income investors are likely to be attracted by potential for the well covered dividend to be hiked at a faster rate than analysts predict. Offering 57 per cent potential upside to my initial 141p target price, TClarke's shares make for a compelling **buy**.

Bull points

- Strong earnings momentum.
- Buoyant full-year performance and record order book.
- Operating margins improving as higher-quality and value-added work undertaken.
- Disciplined approach to tendering for work in five designated market segments.
- Offering full range of electrical and mechanical services improves tender success rate.
- Net funds building strongly.
- High return on capital.
- Progressive dividend policy and upside to payout forecasts.
- Management have significant industry and company experience.
- Regional expansion offers additional growth opportunities.
- Cash-rich balance sheet and new bank facilities mitigate financial risk.

Bear points

- Pension deficit.
- Economic uncertainty.
- Small-cap company below the radar of investors.
- Exposed to financial risk from principal contractors on major projects.

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It's not often you get the opportunity to buy shares in a UK-focused company on a PE ratio of six when the business is set to deliver full-year earnings per share (EPS) growth north of 20 per cent, and is predicted to post another double-digit increase in 2019. The cash-adjusted earnings multiple is even lower still when you take into account a rock solid cash-backed balance sheet. Cash is building up strongly, facilitating a growing dividend.

However, this is the tantalising investment prospect on offer at **TClarke (CTO)**, a nationwide building services contractor based in the heart of the City of London that designs, installs, integrates and maintains the full range of mechanical and electrical services and the digital infrastructure required to create a 21st century building. Founded in 1889, and having listed its shares on the London Stock Exchange in 1948, the company may be a minnow of the market and under the radar of investors, but its 130th anniversary is set to be a vintage one if last month's trading update is anything to go by.

TClarke (CTO)

Ord Price: 90p | **Market Value:** £38.3m
Touch: 88.5-90p | **12-Month High:** 93.6p **Low:** 68.2p
Dividend Yield: 4.3% | **PE Ratio:** 6
Net Asset Value*: 52p | **Net Cash:** £4.6m

Year to 31 Dec	Revenue (£m)	Pre-tax profit (£m)	Earnings per share (p)	Dividend per share (p)
2014	208	0.6	0.9	3.1
2015	242	4.2	7.9	3.1
2016	278	6.2	11.2	3.2
2017	311	6.5	12.1	3.5
2018**	320	7.8	14.7	3.7
2019**	330	8.6	16.3	3.9
% change	3%	10%	11%	5%

SETS normal market size: 5,000
*Includes intangibles assets of £25.8m, or 60p a share
** N+1 Singer forecasts. Pre-tax profits and fully-diluted EPS stated before exceptional items and goodwill amortisation
Source: TClarke annual report and London Stock Exchange

TClarke's services are clearly in high demand. It has just reported a major earnings beat for the 2018 financial year which not only prompted significant earnings upgrades from analysts for this year and next, but highlighted a bullish order book and pipeline for delivery in 2019, and beyond. The company is also delivering an increasing level of profitability on sales, so both sales and margins are on the rise which is accentuating profit growth. For good measure, the technical set-up on the charts is bullish, thus improving the chances of a significant break-out occurring through the 90p to 93.6p share price glass ceiling that has acted as a major resistance level since April 2014.

Operating out of 17 offices across four regions, TClarke has developed long-term partnerships with major principal contractors and property owners and developers, including

"Its businesses are focused on being seen as the partner of choice in each of the specialist areas it works in"

the likes of the NHS, BAE Systems, EDF, John Lewis Partnership, Land Lease Construction, Sir Robert McAlpine and FTSE 100 housebuilders Barratt Developments and Berkeley Group. Projects the company has worked on recently include Bloomberg's London HQ, London's Kings Cross Project that will be the home to media giant Google, and the huge Westfield London Shopping Complex.

A partner of choice for 21st century intelligent buildings

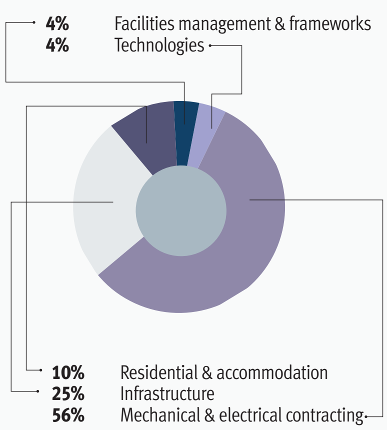
TClarke has been able to win complex project contracts on such iconic London buildings, and continues to do so, because its businesses are focused on being seen as the partner of choice in each of the specialist areas it works in. The company is a trusted partner too and one with a reputation for delivering good value and high quality work.

Specifically, TClarke's activities involve designing and valuing engineer systems, drawing on an innovative approach and technological expertise to provide intelligent building solutions; adding value through procurement of the necessary materials, services and expertise across the life of a project; and deploying a team of over 1,000 highly qualified and experienced in-house engineering professionals and operatives to install and deliver its solutions and services. TClarke's in-house teams also provide a suite of specialist mechanical, electrical and Information and Communications Technology (ICT) maintenance services to support the ongoing functioning of a building throughout its lifecycle.

The fact the company is on course to end the 2018 financial year with a record order book worth £403m (of which £230m is slated for delivery in 2019 thus de-risking forecasts), up from £380m at the same stage in 2017, is testament to how the company continues to win contracts across its five core market segments:

- **Infrastructure:** Rail, airports, hospitals, schools, prison, healthcare and defence projects including work on Luton Airport, Cambridge Judge Business School and Stanmore Hospital. This activity accounted for a quarter of TClarke's annual sales in 2017. High profile awards include work on the ongoing upgrade programme on the London Underground.
- **Residential and accommodation:** New build, refurbishment, hotels and student accommodation work includes contracts on the upmarket residential development at Heritage Grange, Edinburgh, and The Minories Hotel in London's financial district. The segment accounted for 10 per cent of TClarke's annual sales last year.
- **Facilities management and frameworks:** Work here involves onsite facilities management and long-term

TClarke's 2017 revenue by business segment



Source: TClarke annual report & accounts framework agreements. The segment delivered 4 per cent of TClarke's annual sales last year.

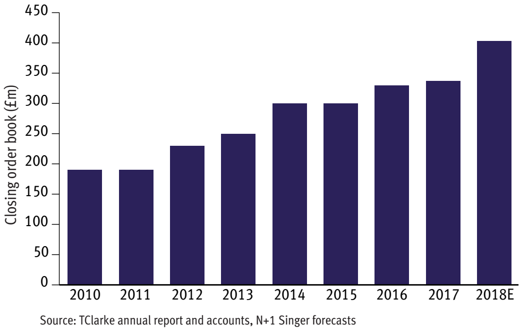
- **Technologies:** This segment involves high tech work on data centres, IT infrastructure and networks, fire and security, and smart buildings. Revenues from this activity accounted for almost 5 per cent of TClarke's annual sales buoyed by work on the Inflexion London 3 Data Centre and electrical infrastructure work on the redevelopment of Battersea Power Station.
- **Mechanical and electrical contracting:** This segment accounts for 56 per cent of annual sales, and has sound prospects as a number of complex iconic buildings are delivered in the coming years including The Kings Cross Project in Central London. Other areas targeted include commercial offices, retail, leisure and sporting arenas, and museums and galleries.

The expansion of TClarke's core markets – which underpin the company's bumper order book, and pipeline of work too - is in part being driven by macro-economic trends, including 'big data' and digital communications which are transforming end user demand in many ways. It also reflects the fact that the company is acknowledged across its peer group as a leader in the engineering skills that enable the vision, design, planning and theoretical engineering required to develop strong, safe, resilient, environmentally positive buildings and infrastructure. It's fair to say that TClarke has a significant role to play in building Britain's future. For instance, the company's mechanical and electrical contracting division has won work on James Dyson's prestigious new global technology campus in Wiltshire.

Last year's small acquisition of Eton – a company that integrates, installs and manufactures building control systems – is playing a major part too. Eton is well regarded in the construction industry in London and the South East, thanks to work on major projects including One Canada Square, Bloomberg London, and the 'Walkie Talkie' tower at 20 Fenchurch Street in the heart of London's financial district. Around 60 per cent of the Canary Wharf Estate uses Eton controls.

Within months of acquiring Eton, TClarke's Intelligent Buildings (TCIB) team and Eton teams collaborated on 22 Bishopsgate, a 62-storey 278m high building with 1.27m sq ft of space located close to the key transport hubs of Bank and Liverpool Street station in the City of London. TCIB designs data networks and Eton will install them. The company is laying 42,000 metres of data cable in the 22 Bishopsgate building, enough to cover the length of the

TClarke's improving forward order book



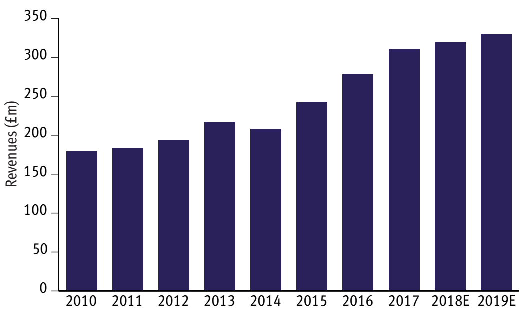
Source: TClarke annual report and accounts, N+1 Singer forecasts

"Since the half-year results in early August, the company has won a further £150m of contract awards"

London Marathon, in order to deliver a complete digital solution for the occupants. It's also laying 163,000 of mechanical pipework too. The two segments are collaborating at the Bank Street development at Canary Wharf too.

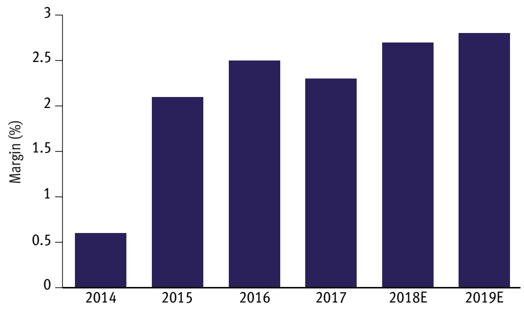
So, as the 'intelligent buildings revolution' becomes a reality, expect TClarke's market-leading in-house capability and expertise to support further major contract awards. Indeed, in the pre-close trading update a few weeks ago the directors revealed that since the interim results in early August the company has won a further £150m of contract awards, including additional works at Phase 2 redevelopment of Battersea Power Station; at One Bishopsgate Plaza, London for the fit out of 160 residential apartments; and at the Global Switch Data Centre, London.

TClarke's revenues on the rise



Source: TClarke annual report and accounts, N+1 Singer forecasts

TClarke's improving operating margins



Source: TClarke annual report and accounts, N+1 Singer forecasts

Strategy for delivering increasingly profitable growth

Prospects for TClarke maintaining the impressive growth in its sales and order book look well underpinned for a raft of reasons, not least of which is the ongoing demand for its services in London and the south east of England – a geographic segment that accounted for almost two-thirds of sales at the first-half stage, and 60 per cent of the contracted order book.

There is a substantial premium market of major London projects and their complexity and programme challenge means that very few rivals can compete with TClarke to deliver the required quality and scale of resource. Indeed, as major projects become increasingly complex, principal contractors and developers need programme certainty to achieve their financial and business objectives. So, by offering complete, integrated building services, covering mechanical, electrical and digital elements with consistent quality and scale, the company can provide one of the most effective ways for principal contractors and developers to manage and control the risks of increased complexity.

In turn, this further differentiates TClarke from competitors in the market place and increases the value it provides to clients, and the return it receives. By targeting higher value-added work, and having a more diversified mix of revenues, TClarke is now earning a higher margin on sales. This is highlighted by the fact that it's operating margin has rebounded strongly from a low point of 0.6 per cent in 2014 and is on course to hit 2.85 per cent in 2019, well on the way to the directors' 3 per cent target.

It's well worth noting that even the newly upgraded forecasts for the 2019 financial year by house broker N+1 Singer could underestimate the strength of TClarke's profit momentum. That's because in November's trading update the directors revealed "(we have) confidence that our underlying operating profit margin target of 3 per cent is attainable in the near future. The strength and reputation of TClarke is evidenced by our record forward order book. We have maintained our market leading position in our traditional markets whilst securing technology-driven projects, where project complexity and specification levels play to our strengths."

TClarke's improving margins

Financial year to 31 Dec	Revenues	Underlying operating profit	Margin
2010	£179m	£7.3m	4.1%
2011	£184m	£4.8m	2.6%
2012	£194m	£2.9m	1.5%
2013	£217m	£3.2m	1.5%
2014	£208m	£1.3m	0.6%
2015	£242m	£5.1m	2.1%
2016	£278m	£6.9m	2.5%
2017	£311m	£7.3m	2.3%
2018E	£320m	£8.6m	2.7%
2019E	£330m	£9.4m	2.8%

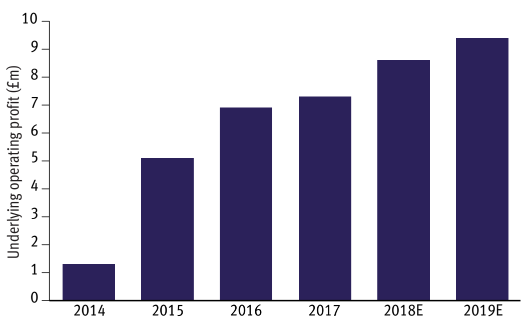
Source: TClarke annual report and accounts, N+1 Singer forecasts

Or put another way, analysts are currently looking for an average operating profit margin of 2.85 per cent based on £330m sales in the 2019 financial year to produce an operating profit of £9.4m. If the actual margin is closer to 3 per cent, then operating profit will hit almost £10m – an outcome 16 per cent higher than that forecast in 2018.

Importantly, by targeting the aforementioned five core market segments, the company is less exposed to the vagaries of the construction market that made its profits lumpier in nature in the past. That's partly because infrastructure projects grow at times when London commercial markets contract, but also because facility management markets increasingly require the expertise the company offers.

Also, the company is well placed to deliver on new build housing market projects to blue chip clients like Barratt Developments and Berkeley Homes, who regard TClarke's residential business as best in class. The boom in the 'build to rent' market is another positive as institutional investors take supply off the market from developers. Irrespective of who buys the properties, they need a high quality building services company to fit them out to a high specification. The diversified revenue mix is a far cry from 2010 when chief executive Mark Lawrence was appointed and TClarke's core business centred mainly on electrical contracting for major projects in London.

TClarke's operating profit momentum



Source: TClarke annual report and accounts, N+1 Singer forecasts

“Partnership is a key feature of the business approach”

Market opportunities

TClarke has been expanding its core offering, while continuing to build a reputation and track record of delivering large-scale mechanical, electrical and ICT projects. This has substantially increased the range and scope of opportunities available to the company in recent years, a key reason why its order book has boomed.

Partnership is a key feature of the business approach nationwide. With the support of long-term clients and partners, the company opened offices last year in new geographic locations (Dumfries, Portishead and Birmingham) and was immediately rewarded with significant contracts. Moreover, the company has recently opened new offices in Liverpool and Manchester. Building upon existing established relationships, bids totalling £40m have been submitted across a range of projects in these areas. TClarke has also secured a place on the four-year £400m Liverpool-based Procure North West Framework. This highlights an agile response by management and one that is exploiting a brand built on high quality delivery from its in-house teams.

It makes sense to target new regional markets in this way as TClarke’s financial strength and reputation, allied to the quality of work and integrated service offering, means the company can offer partners the confidence they need when they are looking to build their projects. There is no doubt there are opportunities to exploit in both Manchester and Liverpool.

Manchester is booming and is now Europe’s second largest digital and creative hub. Salford Quays, where TClarke has located its new office, contains Media City UK. That’s important as the £1bn second phase of the project will see 211,000m² of space built, thus creating a major opportunity for TClarke to tap into.

In Liverpool, there are plans afoot to build 3 million sq ft of office space. Vast schemes are planned, including the £5.5bn Liverpool Waters project (which will occupy derelict dock spaces at Central Docks) and also Wirral Waters which will transform 500 acres of the Birkenhead docklands into an internationally recognisable destination. Many of the company’s traditional principal contractor partners have been making their moves in the city, so this looks the right time and the right place for TClarke.

Admittedly, Brexit has created uncertainties, but the macro effects of globalisation, particularly the gravitation of organisations and business ecosystems to the most attractive hub cities in the world, is also having a powerful effect. This has been beneficial for TClarke in London and it has helped build significant market share in places such as Cambridge, where the company has a track record of delivering laboratory, research and education projects.

“The board maintains a strict policy of only bidding for projects that meet their internal risk analysis”

Importantly, the board maintain a strict policy of only bidding for projects that meet their internal risk analysis and where they are comfortable with the covenant and market reputation of the contractual counterparty. For instance, TClarke was engaged as a sub-contractor on a Carillion joint venture project as part of the Aspire Defence Contract at Tidworth, Bulford and Perham Down. The collapse of Carillion at the start of the year may have hit other sub-contractors, but it was “business as usual” for TClarke’s joint venture project.

In fact, there wasn’t any adverse financial impact arising from any direct exposure to Carillion at all, thus highlighting a reassuring level of risk management in the contracts when taking on this type of work. It’s worth pointing out too that over 95 per cent of the client base is blue chip, so far less likely to default on bills, and credit risk is spread across a large number of customers which reduces any concentration of credit risk. Bad debt expense amounted to only £200,000 last year, a tiny amount in relation to turnover of £311m.

Shareholder value creation

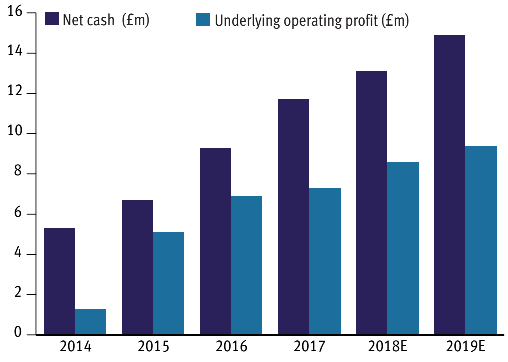
Delivery on a growing order book, and a focus on the five core market segments, has delivered a step change in TClarke’s profitability and finances. The company’s house broker N+1 Singer forecast net cash to end this year at £13m, a sum worth 31p a share or a third of the current share price, up from £5.3m at the end of the 2014 financial year.

In the four year period, underlying operating profit is set to have increased more than six-fold from £1.3m to £8.6m in 2018. The current year forecast was upgraded by an eye-catching £800,000 a few weeks ago after the directors reported their business was trading well ahead of market forecasts. Moreover, analysts also lifted their 2019 underlying operating profit forecasts by £500,000 to £9.4m based on revenues of £330m to reflect the robust forward order book and pipeline of work being bid for - an outcome that could see T Clarke’s cash pile swell to almost £15m by this time next year. That’s a significant sum in relation to the company’s current market capitalisation of £38m.

The bumper cash pile means that TClarke is able to fund an increasing amount of work commitments and the working capital requirements to fulfil them. The company also has new bank facilities that comprise a £5m overdraft facility, repayable on demand, and a £15m revolving credit facility expiring on 31 August 2022. Higher working capital requirements to fund the projected sales growth is the key reason why free cash flow is forecast to drop to around £3.2m this year, recovering slightly in 2019.

However, that level of forecast free cash flow is more

TClarke’s net cash building as profits rise



Source: TClarke annual report and N+1 Singer forecasts

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than adequate for the board to continue with their progressive dividend policy and one should see the payout rise to 3.9p a share in 2019, as analysts predict, up from 3.1p a share in 2015. The cash cost of the 2019 payout is £1.6m, or less than half 2019 projected free cash flow of £3.4m. This comfortable level of cover suggests that there should be upside to the 2019 payout if TClarke achieves a fully diluted EPS of 16.3p in 2019 (up from 14.7p forecast in 2018) given that the payout is also four times covered by forecast EPS. Or put it another way, it's not unreasonable to expect the board to reward shareholders with an even higher payout given that cash is building strongly even after taking into account the working capital flows on the higher level of turnover.

Net cash building as profits rise

Year	Net cash	Underlying operating profit	Free cash flow
2014	£5.3m	£1.3m	£5.1m
2015	£6.7m	£5.1m	£2.9m
2016	£9.3m	£6.9m	£4.3m
2017	£11.7m	£7.3m	£5.2m
2018E	£13.1m	£8.6m	£3.2m
2019E	£14.9m	£9.4m	£3.4m

Source: TClarke annual reports and N+1 Singer forecasts

The other point worth making is that even after paying the dividend, the company is creating significant economic value for shareholders. This is highlighted by a rising net asset value (NAV) per share, which is forecast to rise from 34p at the end of 2016 when NAV was £14.1m, to 61p a share by the end of 2019 (when NAV is estimated to close at £26m). That value added is not reflected in TClarke's market capitalisation of £38m which equates to less than 1.5 times forecast 2019 NAV of £26m, nor for that matter is it reflected in the company's eye-watering post-tax return on equity of almost 30 per cent, based on closing 2018 shareholder funds of £20.8m and a forecast net profit of £6.2m.

The high return on capital is clearly supportive of TClarke recycling its operating cash flow back into the business to provide the additional capital required to fulfil the work commitments the company continues to win.

Meet the management

Improving financials aside, TClarke ticks the right boxes when it comes to the management who are leading the 1,348-strong workforce.

Chief executive Mark Lawrence has held the position for almost nine years and his hands-on approach to the role means that he regularly walks project sites and gets directly involved with the clients, contractors and supply chain. He has held the reins during a period in which the company's

"Executive pay doesn't seem excessive in light of the operational progress being achieved"

offering has become far more balanced and diversified, while at the same time exploiting the opportunity to tender for work on higher technology building projects which command higher margins. The fact that revenues from this segment are growing strongly, and the company is expanding its regional presence by opening new offices, shows an appetite to evolve the focus of the business to meet the requirements of clients in a changing market place.

Mr Lawrence has been with the company for 31 years, only slightly longer than managing director Mike Crowder, whose project leadership has delivered flagship contracts and a series of large infrastructure projects. Finance director Trevor Mitchell, who joined as interim finance director in February and was appointed full-time in August, has extensive industry experience having held finance positions within organisations such as Balfour Beatty and Kier Group. He has also worked with TClarke since October 2016, so knows the business well.

Chairman Ian McClusker is a former Coopers & Lybrand Partner and has held senior executive roles at technology groups Xerox and Unisys, and also at the Association of Chartered Certified Accountants.

Excluding their combined £748,000 annual bonus in the 2017 financial year, the remuneration received by the seven main board members (including three non-executive directors) was £1.4m. This sum matches the total dividends declared to shareholders, so executive pay doesn't seem excessive in light of the operational progress being achieved and the profits being generated for shareholders.

True, aggregate director shareholdings totalling 262,000 shares are insignificant in relation to TClarke's issued share capital of 42.5m shares, but Mr Lawrence and Mr Crowder also have conditional share awards and options over a further 575,000 shares to keep them well motivated.

Liquidity

TClarke may be a minnow of the stock market, but its shares are readily tradable on a tight bid-offer spread of a penny and in a minimum market size of 5,000 shares on SETS. The decent liquidity is a reflection of the fact that the directors have modest shareholdings and the top six shareholders control only 26.9 per cent of the issued share capital which improves the free float.

There were 231 trades through the market in November according to the London Stock Exchange's official data, and bargains of £10,000 are tradable at the bid price, so it shouldn't be an issue building up a decent holding at the market price.

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TClarke's major shareholders

Shareholder	Percentage of share capital
Miton Asset Management	9.8%
Regent Gas Holdings	9.0%
Chelverton Asset Management	2.4%
TClarke Employee Share Ownership Trust	2.1%
Alliance Trust	1.9%
DG Robson Mechanical Services	1.7%
Total	**26.9%**

Source: TClarke Annual Report, London Stock Exchange

Peer group comparison

On any basis, TClarke's shares offer value on a peer group comparison against its five main listed rivals. On a standard price-to-earnings (PE) basis the 2019 forecast multiple of 5.5 for TClarke represents a 33 per cent discount to the average of its five peers, and a thumping 45 percent discount to Severfield, the highest rated company.

This is despite the fact that TClarke is predicted to post the highest earnings per share (EPS) growth rate in 2019 and continues to differentiate itself from competitors by focusing on specialist building services and technology-driven projects.

Peer group comparison

	TClarke	Costain	Keller	Morgan Sindall	Severfield	Van Elle
Share price	90p	345p	551p	1,238p	73p	84p
Market value	£38m	£369m	£397m	£563m	£222m	£67m
2018 EPS	14.7p	36.1p	80.0p	138.7p	6.8p	12.2p
2019 EPS	16.3p	39.2p	87.4p	139.6p	7.4p	13.4p
2018 PE	6.1	9.6	6.9	8.9	10.7	6.9
2019 PE	5.5	8.8	6.3	8.9	9.9	6.3
2019 forecast EPS growth	10.9%	8.6%	9.3%	0.6%	8.8%	9.8%
EV/Ebitda 2019	2.3	4.5	3.7	5.2	5.7	3.4
2019 dividend yield	4.3%	5.1%	6.7%	4.1%	4.1%	5.4%
	TClarke	**Costain**	**Keller**	**Morgan Sindall**	**Severfield**	**Van Elle**
2018 operating margin	2.7%	3.1%	4.5%	2.9%	9.4%	11.6%
2019 operating margin	2.9%	3.3%	5.1%	3.0%	9.9%	12.3%

Forecasts: TClarke (N+1 Singer) and Costain, Keller, Morgan Sindall (Peel Hunt) – these four companies have December year-ends; Severfield (Edison Investment Research forecasts for year-ends March 2019 and 2020, respectively); and Van Elle (Peel Hunt forecasts for year-end April 2019 and 2020, respectively).

The valuation anomaly is even starker if you compare all six companies on an enterprise value to Ebitda basis. Enterprise value is a company's market value plus net debt or less its net cash, and Ebitda is its cash profits as defined by earnings before interest, taxation, depreciation and amortisation. On this basis, TClarke is rated on a bargain basement 2019 multiple of 2.3 times forecast cash profits of £10m, to enterprise value of £23m. This represents between a 49 per cent to 60 per cent discount to the ratings of Costain, Morgan Sindall and Severfield. It also represents a 33 per cent plus ratings discount to the ratings of Van Elle and Keller.

It's not as if TClarke's dividend yield is that low by comparison to warrant such a low rating. The company's prospective dividend yield of 4.3 per cent for 2019 exceeds that of both Morgan Sindall and Severfield. Moreover, as I have pointed out, the risk to TClarke's 2019 payout is skewed firmly to the upside.

Admittedly, TClarke's operating margins are still shy of 3 per cent, but that is not far off the level earned by Morgan Sindall which in terms of business activities is by far the closest comparable amongst the peer group. Moreover, TClarke's margins have been rising strongly in recent years as the company has taken on higher value added work and are set to hit the 3 per cent level in the near future, according to the directors' guidance in November's trading update. Furthermore, the combination of rising margins on increasing sales could deliver even higher profit growth in 2019 for TClarke than analysts currently predict. If TClarke can achieve its 3 per cent target then EPS growth would be nearer to 17 per cent, massively outperforming all its rivals. By comparison the higher rated Morgan Sindall is expected to put in a relatively flat performance in 2019.

Target price

Having taken all the above factors into account, and the risk assessment on the next page, I feel that even after applying a liquidity discount to reflect TClarke's smaller market capitalisation, the shares are being very harshly rated.

If the company is rated on the same enterprise value to Ebitda multiple of 3.4 times as the lowest-rated company, Van Elle, then this would imply a target share price of 115p based on expectations of TClarke delivering cash profits of £10m in 2019 and after factoring in a closing 2019 net funds of £14.9m. However, the risk to TClarke's earnings is to the upside, and you can't ignore the company's appealing 2019 PEG ratio of 0.55 either, suggesting that an enterprise value to cash profit multiple far closer to Costain or Morgan Sindall is fully warranted. This would imply a market value of between £60m and £67m for TClarke's equity, or 141p to 158p a share based on 42.5m shares in issue. That's a realistic target price range and one that the technical set-up is supportive of.

Interestingly, TClarke's shares are again pressurising the top of a four and a half year trading range that has seen major resistance emerge at the 90p to 93.6p price point. However, a series of rising lows has occurred after each pull-back before the next attempt at this glass ceiling has been made, a bullish sign indeed. Moreover, with the reading on the 14-day relative strength indicator (RSI) currently around 60, the shares are no longer in overbought territory and I feel the odds strongly favour the next attempt breaking through this resistance level. I also feel that the chart break-out could happen before TClarke issues what is likely to be another bullish pre-close trading update at the end of January 2019. If I am right, then the re-rating could be sharp given the protracted period the shares have been range bound. A break-out would also open the door for a run up to the May 2010 high (around the 175p level), although my first target is 141p.

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Risk assessment
Of course, there are a number of risks to consider before investing and in the case of TClarke there are several.

■ **Economic risk.** The construction industry is highly cyclical and TClarke is dependent on the planned level of construction and maintenance expenditure by both the public and private sectors. To mitigate economic risk the company has long-term client and contractor relationships and seeks to secure framework agreements to reduce the impact of demand fluctuations due to an economic slowdown.

The company also mirrors principal contractors regionally and focuses on targeted tendering in geographic areas and segments of the market where demand is strong, as highlighted by the recent opening of offices in both Manchester and Liverpool. TClarke also exploits opportunities in specialist markets and sectors such as 'intelligent buildings', a high growth segment for its services.

Furthermore, the company operates throughout the UK using its core mechanical and electrical skill base to enable agile movement in and out of sectors to meet changing market demands. Management monitors the order book to ensure an appropriate balance of work between London and the regions and across the various sectors in which it operates.

The fact that £230m of TClarke's record order book of £403m is slated for delivery in 2019 even at this early stage mitigates the impact on the construction industry in the event of a hard Brexit. Moreover, the company is working on a number of complex and high profile construction projects that will take years to reach completion, so work on them is not going to be adversely impacted by the current economic uncertainty. Also, the company's new regional offices have significant multi-million pound tenders out which if landed will de-risk earnings forecasts even further. The contracted order book for 2020 and beyond is worth £173m in revenues.

■ **Political risk.** The company is subject to complex and evolving tax, legal and regulatory requirements. A breach of laws and regulations could lead to litigation, investigations or disputes, resulting in additional costs being incurred, civil and/or criminal proceedings and reputational damage. To minimise this risk the company monitors legal and regulatory developments in the areas in which it operates, and seeks legal or other specialist advice as appropriate. All employees, suppliers and subcontractors are required to comply with all applicable laws and regulations. Training is provided on legal and regulatory changes as required.

■ **Financial strength.** The ability to secure and deliver work depends on TClarke's perceived financial strength and the availability of cash resources, banking facilities and the ability to provide performance and other bonds as necessary.

This is not an issue as the company's cash balances have increased substantially in recent years and new banking agreements are in place that run through to 2022. Moreover, the board manage the capital structure and dividend policy to ensure adequate reserves are maintained to fund the growth strategy. They also monitor cash flow requirements and seek to match maturity profiles of financial assets and liabilities at contract level. The creditworthiness of counterparties is monitored on an ongoing basis.

■ **Reputation.** The ability to tender for new business and to maintain strong relationships with customers is dependent on maintaining TClarke's reputation for leadership in technological innovation and quality of delivery.

So, to maintain its reputation the company supports high standards of ethics, sustainability and compliance, and is committed to improving health and safety at work. It has instigated an 'Absolute' Accident Reporting Regime, which ensures each accident is reported despite the level of severity. No accident is accepted lightly, but more importantly none are hidden, therefore no statistic is buried. The number of accidents reported declined by 17 per cent last year.

■ **Winning new contracts.** TClarke's ability to secure profitable new work is dependent on its ability to: adequately resource tenders; understand the technical and commercial challenges incumbent in each tender; and price the associated risks accordingly. If risks are underpriced, contract losses and reputational damage may result; if risks are overpriced, the company will not secure sufficient tenders to replenish the order book and grow the business.

To mitigate these risks, a focus on strong relationships helps senior management to understand client needs and focus tendering activity accordingly. The company employs experienced teams of estimators throughout the country, with all bids reviewed by a director and checks carried out to avoid non-competitive pricing.

Importantly, the board is committed to the principle that it will not bid for work below commercially acceptable rates and will only sign off any proposed expansion into new geographic areas or business sectors once a detailed business case is prepared, and approved by the directors.

The fact that tender prices and margins are improving, and the company's order book is at a record level, is indicative of a tight market place where clients and principal contractors are seeking to lock in mechanical and electrical engineering resources, factors which are positive for TClarke winning further contracts.

■ **Contract delivery.** TClarke concurrently runs several hundred contracts across the country, some of huge complexity. They require high-quality, proactive management to ensure delivery of value objectives for all stakeholders. Failure to deliver could result in significant financial and reputational damage.

To mitigate these risks, the company carries out an ongoing assessment and management of operational risk throughout project lifecycle, and contracts of a significant size or risk are regularly reviewed by executive management and discussed at board level. Profit and cash flow are monitored too, with regular reviews at contract and business unit level.

In terms of the workforce, all key suppliers and subcontractors are subject to regular performance reviews, and TClarke is committed to training and maintaining its industry leading teams of directly employed engineers, surveyors, supervisors and skilled tradespeople. One risk is that as the construction sector grows, increasing demand for scarce engineering, commercial and site-based resources is making recruitment and retention of employees more difficult. So, to develop new talent internally, the company offered 49 new apprenticeships last year as part of a programme designed to identify and support future leaders of the business.

To guard against liability claims, adequate insurance cover is taken out and reassessed every year.

■ **Supply chain.** To deliver projects to the correct specification and to budget requires the availability of components and materials of sufficient quality and at the right price. The majority of projects TClarke secures do not allow for the recovery of increased material costs. To mitigate this risk, formal supplier framework agreements are maintained with prices locked in through procurement at the beginning of a contract wherever possible.

■ **Pensions.** TClarke's defined benefit retirement scheme has assets of £40.3m and post-retirement liabilities of £59.2m, so has a £18.9m pension deficit. This is significant in the context of the company's net assets of £22.3m at the end of June 2018.

It also means that the company is heavily exposed to funding risks arising from changes in longevity, inflation and investment assumptions in relation to its defined benefit pension scheme. To mitigate the risk of the defined pension scheme deficit increasing, TClarke closed the scheme in 2015, and will make a deficit reduction contribution of £1.25m this year, rising to £1.5m per annum thereafter with a view to eliminating the pension deficit by March 2029.

■ Potential fraudulent activity by an employee. However small the possibility, there is always potential for a rogue employee to act fraudulently in any business. This impacted the company in October 2016 when TClarke discovered financial irregularities within the accounting function of a wholly-owned subsidiary, DG Robson Mechanical Services, and specifically the misappropriation of funds by a former employee of DGR and related parties.

The company reached an out-of-court settlement with the former employee for cash payments of £1.43m in full and final settlement of all claims by the company and its subsidiaries against the individual concerned and related parties. It has received £1m of this sum to date. TClarke continues to pursue other third parties in order to recover the balance of the misappropriated funds.

The isolated incident did not impact the wider TClarke Group and was limited to DG Robson Mechanical Services and its business operations have since been transferred to the company's main London mechanical and electrical contracting business, where additional controls are in place. To mitigate this ever happening again, TClarke implemented a revised internal control framework. This resulted in standardised processes across the business and segregation of duties both geographical and functional. Systems access has been overhauled, too.

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