UK Housebuilders: If the System ain't Broke?

BUY Barratt @ 77p

BUY Taylor Wimpey @31.5p

- **'Feel sick' moment, time to buy.**
- **Stocks now heavily discounting a 'broken system' where bank lending retrenches further and real house prices drop >10%.**
- **E.g. BDEV gross profit margins can increase from 11.5% (2011e) to 18% (2013e) on current land bank, giving a PE of 4x recovered earnings. +180% upside to Tangible NAV. Sector now in deep value category.**
- **Sector management is at least on the same page, building for a flat volume and flat price scenario with little incentive to cut prices.**

Company	Barratt Developments PLC
Recommendation	BUY
Price	77p
Price Target	150p
Upside	~100%
Price Downside	50p
Downside	-35%
Relevant Valuation Metric	Price to Tangible NAV
Current Multiple	0.35x

We met Barratt and Taylor Wimpey last week.

- In 2011, Barratt, Taylor Wimpey and Persimmon (the main 3 volume players) will build and sell around 10,000 homes each at roughly 7-9% operating margins.
- All three trade at significant discounts to Tangible NAV (Net Landbank + Work in Progress). Barratt 0.35x, Taylor 0.54x, Persimmon 0.7x.
- If ASPs and Volumes remain flat in the UK, then earnings and cash flow will be rebuilt to around 2x the current level due to better gross margins on the land bank acquired during the downturn.

Caveat: Our research is based on fundamental analysis, but the binary overlay is clearly the **outlook for the banking system**. The system is reliant on banks offering LTVs of 80% or better to help people in the UK buy £175,000 houses for the next five years. These stocks have moved into the **'untouchable category' for most fund managers**, as homebuilder equity is the cherry on a cake that the market believes to be rotting at its foundations. **We feel these risks are heavily discounted** and although it is difficult to see political solutions to the banking system, it is time to take some measured risk. If the current status quo is maintained there is 2-3x upside in the stocks.

Analysis

- Management teams are committed to growing margins and pursuing a price over volume strategy. This is extended through the organisation. E.g. Taylor Wimpey now give 'disincentives' to regional managers in the form of penalties for exceeding volume targets.
- Demand is stable, constrained by mortgage availability at 40,000 homes per month. Housebuilders are building to this new reality.
- The industry is building around 100,000 new homes per year, compared to estimated household formation of 200,000 per year. Small, private housebuilders are constrained, so the large 3 can take share.
- In a downturn, housebuilders will stop land buying and cash generation will explode.
- Industry expects land sales from the UK banks at attractive prices. Hence there is discipline on land purchase ahead of this.

Valuation

- Barratt's net landbank consists of gross land £2.2bn and £0.5bn land creditors (net landbank £1.7bn, market cap £0.7bn). On top of this WIP of £1bn, deduct average net liabilities leaves a tangible NAV of £2bn or 209p per share. Net debt average around £0.7bn and Pension deficit £50m. 0.35x Market cap to tangible NAV.
- In a flat house price and flat volume scenario, BDEV can make around £131m net income next year and £189m the year after. This would all be cash flow as the company would likely be working capital neutral (no extension of land bank from current 4.8 years).
- The margin increase is driven by the percentage of impaired old land and non-impaired old land dropping from 83% to 49% of the mix. Non-impaired new land carries gross margin of >20% and goes from 17% to 39% of the mix.
- If the market collapses (ASP drop greater than 10% and volume drop -10-20%) it is likely the sector stops land purchases. At this point, although profitability drops to zero, the inventory side of the balance sheet drops, releasing the tangible NAV in the form of cash. A 10% write down on land and WIP would cut NAV by around 40p to 160p. The stock is trading at 74p today. Barratt and Taylor Wimpey are probably trading below liquidation value.

What's different from 2008?

- Volumes are at 50% lower levels, so housebuilders are less dependent on maintaining volumes.
- Balance sheets are stronger, following capital raisings, refinancing and disposals. Banking covenants have been rewritten during the downturn and factor in stress tests for -50% reductions in NAVs and covenants are cash flow, not interest cover based. Last time, housebuilders struggled to generate cash to meet onerous covenants, which created a negative spiral.
- There is no excess inventory to clear.

Consolidation?

- The discount to tangible NAV raises important **capital allocation questions** for management teams.
    - Firstly, why are they buying land at 100p in the pound when they could buy their own stock for 40p in the pound?
        - Cannot buy back stock with debt (all three companies have some net debt).
        - Pay down of pension deficits should take priority on cash flow. Pension deficits are an additional risk factor in a downside equity market scenario.
        - Buying back stock is an irreversible decision.
        - Not management's job to speculate on the share price.
        - Been burned before buying back stock and consolidating at peak of the market.
        - Raised new equity in this downturn, now buying own stock is difficult.
- This therefore raises the question of consolidation.
    - Amazing that the sector consolidated at the top of the market by paying premium to NAVs on inflated NAVs (2007).
        - Within sector consolidation would be difficult with equity valued so cheaply.
            - Inability to raise new equity or debt finance to buy each other.
            - Limited synergies, operational structures already cut dramatically.
        - In a world of negative real interest rates, UK land at 40p in the pound could be an amazing investment for a corporate with access to capital. Remember, for all the noise and gloom, the UK is short of land and housing with a growing population.
            - Middle-East/Asian sovereign funds. Global infrastructure funds (e.g. Temasek). Private Equity. This is just speculation and something to consider.

Meeting Notes:

Barratt

- Please see previous notes for more details on BDEV.
- Barratt are looking to monetise their shared equity loans, of which they have around £120 to £125m that they could sell. These loans were written down by 40% at point of sale, so represent £200 to £208m of home value. Barratt would not sell these below 1x book, and so any sale would be accretive for shareholders and put a marker down on the tangible NAV value.

Taylor Wimpey

- Regional units have been reduced from 39 to 24 giving much greater efficiency.
- Taylor Wimpey have achieved significant build cost reductions and now expect fairly flat costs over the next 18 months, with some upwards pressure afterwards. The inflation in energy and materials is being felt by the raw material suppliers (e.g. brick makers), not the housebuilders. Labour is less constrained.
- Taylor Wimpey is achieving an expected 22% gross margin on current land purchases.
- Taylor Wimpey has a 6.5 year landbank and would become cash generative in a downturn as they can delay land purchases.
- The £600m sale of the US business (1x book) has greatly improved the balance sheet. Net debt is just £166m.

- Taylor Wimpey are making an annual cash payment of £46m to the pension funds to close the £240m deficit. This payment could be reduced following another valuation. The pension deficit should be considered on TW.
- Taylor Wimpey has a strategic landbank of 77,788 plots (of which they have at least a 50% chance of getting planning) This is in the book at £135m = £1,735 per potential plot. ⅓ of this is owned freehold, with options on the other ⅔, but if these were exercised the cost would be £5,200 per plot, whereas plots in the open market today cost £20 – 30,000.
- Strategic land tends to have margins of 25%, versus 17-18% for short term land. Taylor wimpey had around 14% of completions based on strategic land last year. Strategic land is completely ignored by the market at the current share price.

Appendix

See this article in the Telegraph for comments on UK housing:

"Home ownership to slump to 'mid-1980s levels'

Home ownership in the UK will slump to its lowest level since the mid-1980s over the next decade, leading to an "unprecedented crisis" in the housing market, the National Housing Federation (NHF) has warned.

By James Hall, Consumer Affairs Editor. 7:00AM BST 30 Aug 2011.

High property prices, strict lending criteria from mortgage companies and the need for large deposits could effectively lock millions of Britons out of the housing market. This comes at a time when rents are rising, social housing lists are getting longer, and not enough new houses are being built, said the NHF, which represents England's housing associations.

David Orr, the chief executive of the NHF, said that the UK housing market is "totally dysfunctional" and called for an urgent increase in the construction of new houses to ease the crisis. He said that millions of people face "increasingly limited options" in terms of their future housing arrangements.

London will be particularly affected by falling ownership. By the end of next year, the number of Londoners renting their homes is expected to overtake the number of people who own their homes for the first time in recent history. Last year some 51.6 per cent of Londoners owned their homes, with the balance renting. It is predicted that by the end of 2012 the proportion of owners will fall to 49.9 per cent as rising house prices deter new buyers. By 2021 this will hit just 44 per cent, said the NHF. Across the UK, home ownership is expected to fall to 63.8 per cent in 2021 from a peak of 72.5 per cent in 2001. At present, 67 per cent of the UK population own their own home.

The North East will be the only English region to see any increase in owner occupier numbers over the next decade, rising marginally from 66.2 per cent to 67.4 per cent. Meanwhile, the average house price in England will rise by over a fifth over the next five years from £214,647 in 2011, to £260,304 in 2016, according to Oxford Economics, which produced the forecasts for NHF. The NHF said that for hundreds of thousands of people locked out of the housing market the options open to them "will be limited and increasingly expensive".

"We forecast steep rises in the private rental sector, huge social housing waiting lists, and a house price boom – all fuelled by a chronic under-supply of homes," the group warned. Rents are expected to rise too. Over the next five years rents will increase on average in England from £486 a month in 2011 to £582 a month in 2016, meaning tenants would be paying £1,152 more a year in total. At the heart of the problem remains a marked under-supply of new homes. In 2011 just 105,000 homes were built in England – the lowest level since the 1920s. Plans for more than 220,000 new homes have been abandoned by local authorities since the Government announced the abolition of regional house building targets last year. The Government is proposing increasingly unusual ways to ease the housing crisis. Last week Grant Shapps, the housing minister, said that local authorities should encourage residents to live on boats to ease Britain's lack of affordable housing.

The NHF argued that more government investment in affordable housing would stimulate a wider, faster economic recovery and help fix the UK's "broken" housing markets. Mr Orr said: "Home ownership is increasingly becoming the preserve of the wealthy and, in parts of the country like London, the very wealthy. And for the millions locked out of the property market the options are becoming increasingly limited as demand sends rents rising sharply and social homes waiting lists remain at record levels. "At the heart of this crisis is a chronic shortage of new homes. Despite the overwhelming need to increase supply, house building has slumped to a 90-year low, plunging the country even deeper into the mire."" (Source: telegraph.co.uk).

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