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FIXING THE BROKEN HOUSING MARKET

Mitchell Fraser-Jones, 29 June 2017

This post is part of a series explaining why we are more positive on the UK economy. Find out more

Having been invested in the housebuilding industry for much of the 1990s, a more cautious view of the UK economic outlook prompted a reassessment of its prospects in the early years of the new millennium. For much of the last 15 years, this lack of confidence in the outlook for UK economic growth, coupled with concerns about house price valuations, has led us to consistently conclude that UK housebuilders have not represented an attractive enough investment proposition.

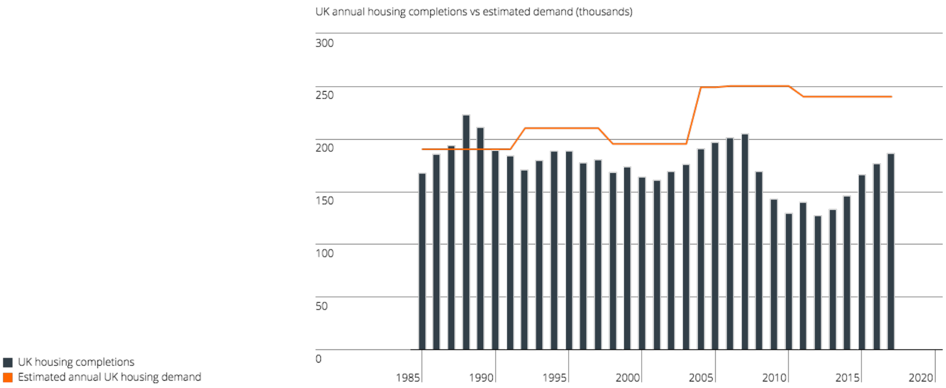
This stance stood our strategy in good stead through the global financial crisis, which created significant operational and financial stress for many UK housebuilders (Barratt Developments and Taylor Wimpey, for example, both issued new equity in 2009 to shore up their balance sheets). However, with house prices not fully correcting in the ensuing recession, and with an expectation that UK growth would remain muted while the banking system went through a protracted period of rehabilitation, we remained cautious on the prospects for the industry.

Despite a lack of broader economic growth and a broken banking system, housebuilders have, nevertheless, enjoyed a long period of cash-generative expansion, in part, more recently, as a result of a growing acknowledgement by the government that the UK needs to build more new homes and make it easier for first-time-buyers to get on the property ladder.

In recent months, an increasingly benign view of the UK's economic prospects combined with the wider market's antipathy towards domestic cyclical businesses in the aftermath of the EU referendum, has created a contrarian opportunity to revisit the sector for the first time in many years.

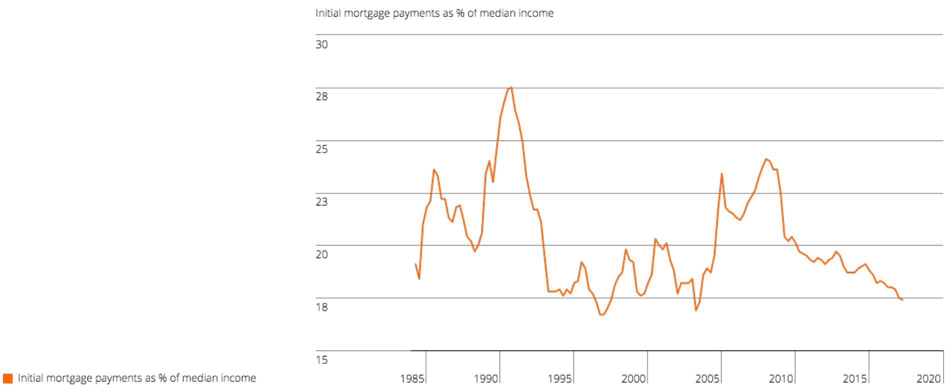
From our perspective, UK housebuilders and the construction industry more broadly, now look poised to benefit from structurally positive fundamental dynamics and, with housing identified by both major parties as a key campaigning topic in the recent election, a long-term opportunity which is underpinned by the public sector.

The UK hasn't built enough houses to meet demand since 1990
Source: Peel Hunt, Woodford



Fixing the UK's 'broken' housing market inevitably means building many more homes and, although some have concerns about valuations, from an affordability perspective, with interest rates at record lows, mortgage repayments represent a much smaller part of take-home pay than is normally the case.

From an affordability perspective, UK housing has rarely been cheaper
Source: The Lazarus Partnership, Woodford



Importantly, this investment case is about volume not price – higher interest rates or a material price correction could undermine it, but we do not expect either to prevail. Indeed, modest house price increases are possible across much of the country.

Conventional wisdom would suggest that the benign economic environment that we expect would result in higher inflation and therefore, in turn, higher interest and mortgage rates. This is still not a 'normal' economic environment, however, and much has changed in recent years – labour market dynamics, globalisation, demographics – that fundamentally shift the old relationships between growth, inflation and unemployment. As a result we expect any domestic inflationary pressures that result from better economic growth rates to be offset by the continuation of broader deflationary influence.

Furthermore, on the subject of house prices, although it is hard to argue that all house prices are too cheap, it is equally difficult to claim that everywhere is too expensive. Despite some pockets of overvaluation – the London property market is a prime example here – most of the rest of the UK appears more reasonably valued (in line with long-term averages) and we therefore do not anticipate a material house price correction. We would, however, argue that a meaningful correction in UK house prices has already been priced into the valuations of housebuilders and other construction-related companies.

As a result, we have been keen to take advantage of this contrarian opportunity to invest in undervalued housebuilders, construction and indeed property companies, with a view to enjoying their attractive yields, sustainably growing dividends and, over time, as the market recognises that these businesses are not as challenged by the economic outlook as share prices would imply, a return to more appropriately attractive valuation territory.

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