

UK housebuilders: the foundations are in place for attractive returns

By Andrew Evans, Fund Manager

Having carried out emergency repairs post the financial crisis, UK housebuilders are better positioned to navigate any future economic volatility and remain an attractive hunting ground for investors at current valuations.

There are three key reasons why we believe selected housebuilders are attractive. Firstly, there has been a cultural change in how they manage their businesses. Secondly, there have been significant changes for the better in the land and planning environment. And finally, valuations are attractive.

The great recession and cultural change

The sector was hit particularly hard by the financial crisis in 2008-2010, finding themselves heavily leveraged on debt. Having overextended their balance sheets in search of growth at the peak of the housing boom, large falls in UK house prices and sales volumes left builders scrambling for cash and having to write down their land banks. The net result was that share prices fell dramatically across the sector.

In the past decade, however, there has been a real cultural change with housebuilders now being run in a much more conservative fashion. Firstly, they have dramatically reduced their dependency on debt. Most homebuilders now operate with net cash balance sheets – unheard of in the past and a dramatic acknowledgement that theirs is a cyclical industry. Secondly, most builders are focusing on generating high returns on capital, building a sensible number of homes and not chasing volumes higher. This reduces the risk of over-extending themselves in a rush to buy land. Finally, and as a result, with balance sheets repaired, housebuilders are returning almost all their profits to shareholders in the form of dividends.

Another positive change is the market share of the biggest builders – around 60% now compared to 31% pre-crisis. A consolidated industry creates a more orderly market and benefits the large incumbent builders.

These changes, taken together, should make the sector more resilient in any future downturn.

Supportive policy measures from the government

Access to land for builders has always been a problematic issue. The National Planning Policy Framework (introduced in 2012) has improved supply by making it much easier for builders to acquire land and get planning passed at the local level. Net additional dwellings in England have grown from less than 150,000 in 2012, to over 200,000 in 2018, endorsing the policy. There is a supportive backdrop with both major political parties in favour of more housebuilding and the Help To Buy scheme (recently extended).

Valuation is attractive

Most of the sector trades on dividend yields of 7% - 10%, free cash flow yields of over 7% and PE's of 7x-8x, providing a fertile hunting ground for opportunities. Our Sanlam Active UK Fund invests in strong businesses at attractive valuations, using a buy-and-hold approach. The fund invested in Taylor Wimpey after a big sell off last year. Taylor Wimpey changed its business strategy post the financial crisis, and we believe the company is now a best-in-class operator with a conservative management and a nationwide footprint. It is generating a return on capital of 20% and is attractively valued. The shares are trading on a 8x PE, an 11% FCF yield and a dividend yield of 11%. The current share price implies a very serious and prolonged downturn in the UK property market, which we do not envisage.

A favourable outlook, in spite of current challenges

Challenges for the sector remain. Rising rates make borrowing tougher for potential homeowners. Labour costs have been rising for a number of years, though this is manageable at present. Finding enough skilled staff has been a challenge for builders and there are no easy fixes.

While more clarity on Brexit would be welcome, most builders have been reporting solid order books and outlooks, with the sensible caveat that the near term environment remains uncertain.

But the fact remains that the UK is structurally undersupplied in housing and desperately needs more homes. The reforms made in the aftermath of the financial crisis have made a real difference, and volumes of new houses built have increased dramatically.

Builders are delivering high returns on capital and returning cash to shareholders. Balance sheets are strong, which should make them more resilient in any downturn. The foundations are in place for attractive returns at current valuations.

The fund invests geographically in a narrow range, there is an increased risk of volatility which may result in frequent rises and falls in the Fund's share price.