THE LEEDS COLLECTIVE

MARTIN CURRIE
A Franklin Templeton Company

UK EQUITIES

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For professional investors only

AN EARLY CHRISTMAS PRESENT FROM THE UK'S HOUSEBUILDERS

Throughout 2023, investors have been hard pushed to evade the relentless media negativity surrounding inflation, interest rates, and what this means for the UK consumer. With this in mind – let's take a minute to think about what areas of the market have generated the greatest returns year to date?

What was top of your list? Consumer staples as an established defensive haven? Perhaps basic resources, a typical inflation hedge? Both wrong.

It will surprise many investors that one of the greatest contributors to UK equity performance this year (behind only energy) have been consumer discretionary businesses, with the housebuilders in particular returning 8% vs the market's benign 0.25%.

We cannot underplay the long-term significance of higher interest rates considering 133,000 mortgages are repricing every month, at an average cost of £288 per month to mortgage holders.

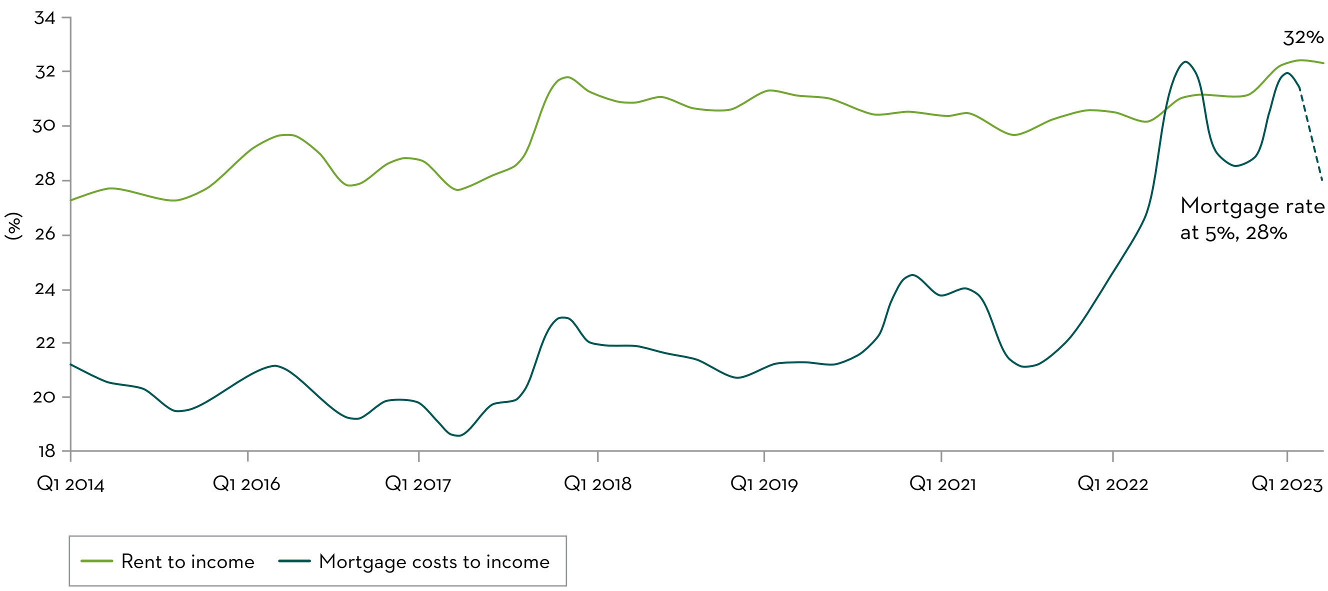
With 1.6 million mortgages set to reprice next year, investors are clearly concerned about the impact of higher interest rates. Many of the housebuilders are reiterating this theme operationally, with general consensus that volumes in 2024 will be challenged. But with the sector very well capitalised, and many of the constituents boasting large and attractive land banks, we believe that it is time to **build a case for the housebuilders...**

The resilient consumer

Following the doldrums of 2022 where real wage erosion descended to 3%, real wage growth is back. Latest Office for National Statistics (ONS) figures demonstrate that wages grew in real terms by 1.4% between July and September 2023[1], and with October's inflation print falling sharply to 4.6% we estimate that real wage growth will strengthen further at the next release in December.

Considered alongside the UK's healthy buffer of excess savings which remains near record highs, and house prices falling by over 5% in some areas of the country, we believe that this supports the case for home ownership over rental. In fact, rent inflation continues to persist and is far less sensitive to shifts in interest rates. Even at the peak in this interest rate cycle, rental costs as a percentage of income remain higher than mortgage costs as a percentage of income, and we believe that the ongoing mortgage price war amongst the market's largest lenders will see this figure fall further into 2023 and beyond (figure 1).

Figure 1: UK rental costs to income vs mortgage costs to income



Source: Citi as at 13 October 2023.

Source: Bloomberg as at 31/10/2023 unless otherwise stated.

[1]Source: Office for National Statistics. Average weekly earnings in Great Britain: November 2023

Cyclical recovery in demand

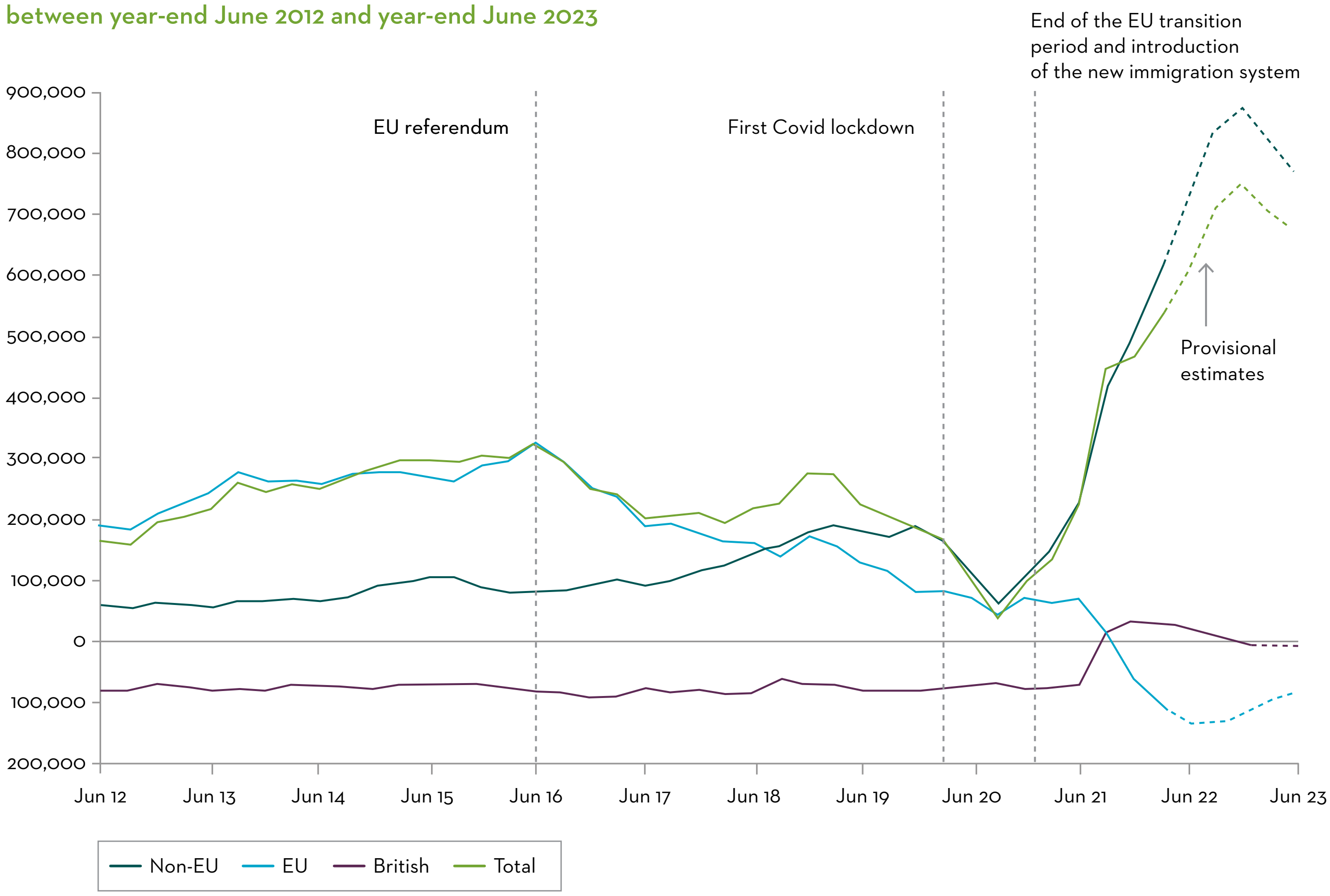
Affordability has undoubtedly been tight and this has fed through to corporate earnings, which are arguably at trough levels as sector average profit before tax (PBT) has retrenched c 60% since 2019. But many of these businesses are in net cash positions. This headroom facilitates the flexibility to invest opportunistically supported by healthy land banks – in the residential property developer Bellway's case comprising of nearly 100,000 plots.

Labour costs are falling caused by an abundance of bricklayers, and building materials are beginning to moderate after several years of covid induced inflation. These themes go some way to offset the enhanced price incentives that housebuilders have been forced to adopt and should support margins in the years ahead. Admittedly, volumes next year will be lower, but our view is that the sector will remain profitable given the low debt levels, improving affordability, and the potential of a new government emphasising the criticality of home building.

Structurally, net immigration remains at eye-watering levels with the figure hitting 745,000 in 2022, a calendar year record (figure 2). This has mainly been driven by non-EU nationals seeking employment in the UK, and has resulted in a 1% population increase between mid-2022 and mid-2023 – the largest such increase since 1962. This feeds into the long-term undersupply of housing in the island nation of the UK.

Historical housing need is estimated at around 250,000 new homes per annum versus current supply trending sub-200,000. These estimates are based on a more moderate immigration figure so are likely to be understated, thus an attractive industry demand dynamic is emerging.

Figure 2: Net migration of non-EU, EU, and British nationals in the UK, between year-end June 2012 and year-end June 2023



Source: ONS as at 23 November.

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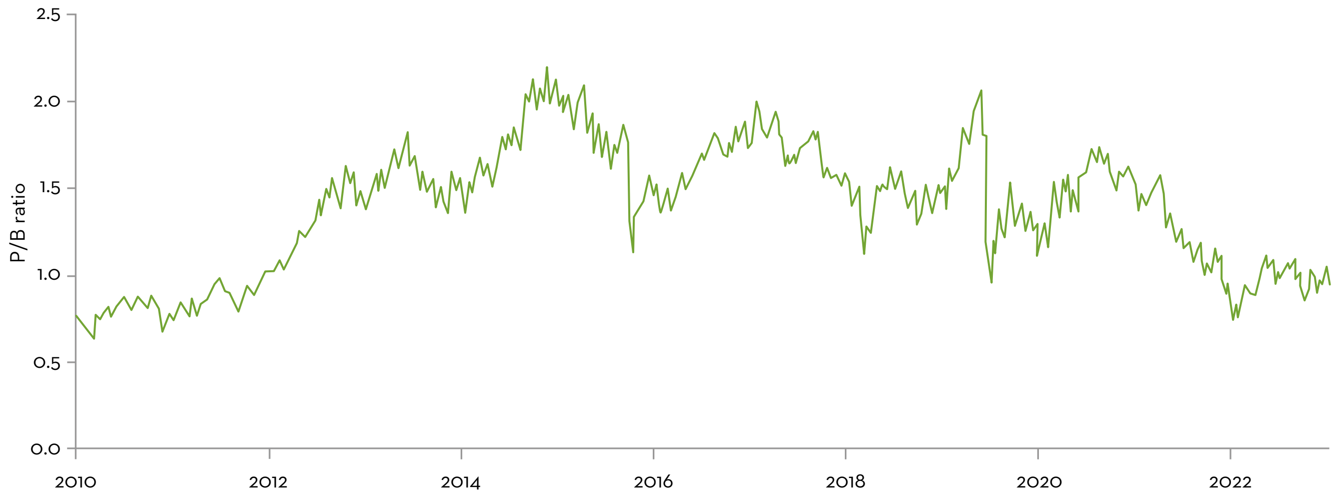
Source: Bloomberg as at 31/10/2023 unless otherwise stated.

Cheaper than cheap?

The UK remains historically cheap according to several metrics, and the house builders are no exception. At present, the sector is valued on a 12 month forward price/book ratio of around 1x, compared to the long term average of 1.4x and peak mid-cycle multiple of 2x (figure 3)[2].

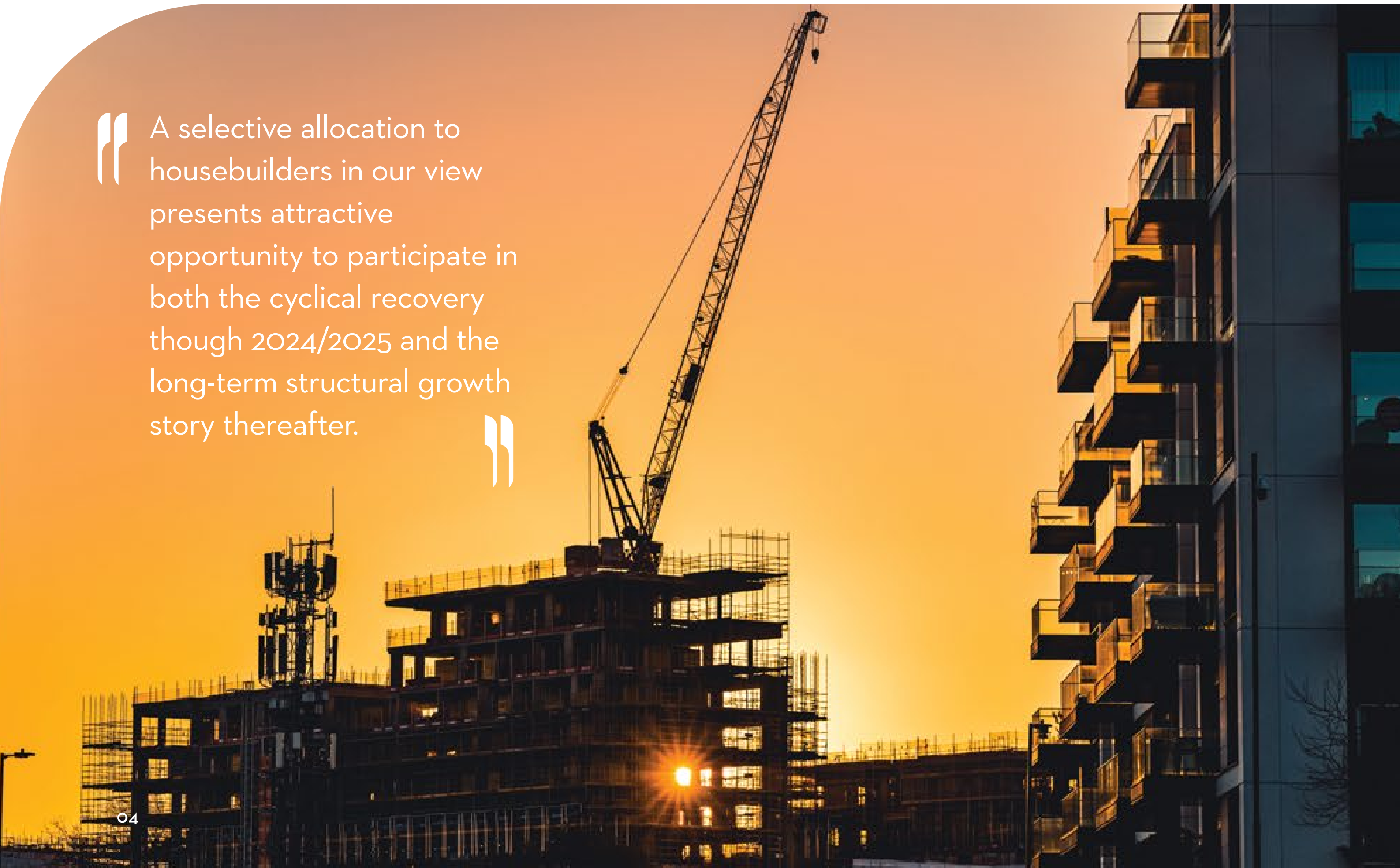
Yes, volumes will be challenged next year, but as pricing and affordability improve for homebuilders and customers respectively, earnings momentum could begin to unlock some of this potential. A selective allocation to housebuilders in our view presents attractive opportunity. Both to participate in the cyclical recovery though 2024/2025, and the long-term structural growth story thereafter, in some cases at a present discount to book assets.

Figure 3: UK Housebuilders forward price/book ratio



Source: Citi as at 13 October 2023.

[2]Source Citi as at 13 October 2023.



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