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Building back better

Evan Lorenz writes:

You can have good news or good prices, but not both at once, ancient wisdom teaches. Thus, in America, on the one hand, we have good news and the speculatively airborne Nvidia Corp., while in Britain, on the other, we have bad news and the speculatively grounded Vistry Group plc (VTY on the London Stock Exchange). In preview, *Grant's* is bullish on the U.K. housebuilder.

As for Britain's bad news, there's seemingly no end to it. A technical recession (i.e., two consecutive quarters of real GDP decline) is knocking on the door, the long post-Brexit funk persists ("Britain has become a bad country to be hard-working, decent and honest" —London *Daily Telegraph*, Jan. 13), the Labour Party is making hay in what's shaping up as a general election year and the share of local stocks in the portfolios of British pension funds has sunk to an all-time low, according to the Office for National Statistics. No wonder the FTSE 100 trades at 10.1 times trailing earnings, less than half the S&P 500's multiple of 21.9 times.

Vistry, which came into the world in 1885 as C. W. Bovis & Co., a general contractor, built Marks & Spencer plc stores in peacetime and munitions factories in wartime before turning to residential construction in the early 1950s. By 2016, Bovis had become one of the U.K.'s largest housebuilders, earning two stars from its consumers in a quality survey conducted by the Home Builders Federation. Unfortunately, that was two stars out of five—and five was the standard that every large British housebuilder was expected to earn and keep (and which Bovis itself had held until 2012). The missing three pips presented the Bovis front office with the alternative of changing or dying.

Choosing change, the board selected Greg Fitzgerald as CEO in 2017. Fitzgerald was a serial entrepreneur in the housing industry. In 1997, he sold Midas Construction to Galliford Try Holdings plc and went on to found Gerald Wood Homes. Selling that business to Galliford, he stayed on to run Galliford's housebuilding division. In 2005, he was promoted to CEO and held the top spot until his temporary retirement a decade later.

From the time of his appointment, Fitzgerald needed just 18 months to regain Bovis's five-star quality rating. And now he's leading the company's pivot to a higher-return, less-capital-intensive business model. "He's really impressive," Aynsley Lammin, who rates Vistry a hold for Investec Bank plc, tells me. "He got margins back up and got on top of all the site issues, construction and operational management of the business. He did a good job."

But Fitzgerald was not content to rest on just those laurels. On Nov. 7, 2019, Bovis announced the acquisition of Linden Homes and the "partnerships and regeneration" businesses from Galliford for £1.2 billion—and promptly renamed itself Vistry Group. In 2022, Fitzgerald led the acquisition of former *Grant's* pick-to-click Countryside Partnerships plc for £1.4 billion (see the issue dated April 30, 2021).

Legacy-model housebuilders typically buy land and lug their purchases through Britain's infamous development-averse planning councils to secure the right to break ground. (A headline in the Dec. 21, 2023 London *Times* conveys what they're up against:

Vistry Group plc at a glance
all figures in £ mns except per share data

	TTM*	2022	2021	2020	2019
sales	£3,159.5	£2,771.3	£2,359.0	£1,811.7	£1,130.8
operating profit	244.3	212.5	285.4	91.7	192.6
net income	200.9	204.3	254.1	76.8	152.0
earnings per share	0.71	0.86	1.15	0.35	1.01
shares outstanding	345.1	236.2	221.8	220.9	136.3
cash	213.0	676.8	398.7	341.0	362.0
debt	541.6	558.6	164.3	303.1	0.0
total assets	6,005.1	6,015.7	3,843.2	3,632.2	1,795.2

*12 months ended June 30, 2023.

source: company reports

"Want to build? Better hire a good lobbyist"). The process tends to take four years, and the difficulty in securing permissions goes a long way to explaining why residential construction has undershot new household formation every year since 1980, as David Capital Partners, LLC, Vistry's ninth-largest shareholder, points out.

The former Galliford unit and Countryside, by contrast, focus on what is locally known as the partnership model, in which builders team up with public authorities (state agencies that provide affordable housing) and others. As a rule, the public partner contributes the land while the builder designs and constructs a relatively high-density development with a mix of affordable public housing, private rental stock and private homes as well as schools and playgrounds.

The partnership model has several benefits. Local housing authorities, which typically manage older buildings, are land-rich but cash-poor. Partnership construction revitalizes their communities and boosts rental income. Tenants benefit from newer dwellings with the latest appliances. While operating margins are lower in this type of work than in the legacy kind (Vistry targets 12% while run-of-the-mill housebuilders aim for 20%), returns on capital are higher (40% versus the mid-teens); they would almost have to be, in the absence of land purchases.

Then, too, by working with its partners, Vistry is able to lock in those returns. "If the project economics are not living up to where they need to be, they do project phasing and can adjust the next phase," Adam Patinkin, the managing partner of David Capital, tells me. "Maybe there were three playgrounds that you were originally going to build, now you are just going to build two." On the flip side, Vistry shares the bounty when returns exceed expectations, by remitting extra proceeds to local authorities (called "priority profits") or by adding amenities.

The partnership business tends to be recession-resistant (Countryside's partnership profits, for example, grew in the 2007–09 downturn as did Vistry's during Covid), since affordable and private-rental units, which make up around two-thirds of construction, are usually pre-sold. There was another test case in the first half of 2023, when—higher interest rates notwithstanding—year-over-year revenues rose by 7.1% in the partnerships segment but tumbled by 28.3% (on a pro forma basis for the acquisition) in the housebuilding unit.

In the United States, NVR, Inc. has implemented a similarly capital-lite model by acquiring land with options rather than through outright purchases. Suffice it to say that the stockholders do not regret it. Over the past three decades, the share price of NVR has compounded at an annual rate of 28.1%. Well aware of this happy history, Vistry named Paul Whetsell, who served on NVR's board from 2007 to 2018, to its board of directors last year.

When Vistry acquired Countryside, 45% of the combined business was in partnerships, the balance in housebuilding. "[I]f the market doesn't recognize the value of the combined group," Fitzgerald proclaimed on the Sept. 5, 2022 call divulging the deal, management would pursue strategic alternatives.

One year later, Vistry did just that, announcing the unwinding and merger of its legacy housebuilding unit into the partnerships business. As the pivot proceeds, Fitzgerald is targeting some aggressive medium-term goals: a company-wide 40% return on capital, revenue growth of between 5% and 8% and an operating profit of £800 million, up from consensus estimates of £442 million in 2023.

To switch to a 100% partnership model, Vistry will use a portion of its land bank to complete its remaining commitments in old-style, so-called volume, construction. It will sell a portion to other builders and, when possible, repurpose land for partnership-style developments. On Nov. 7, 2023, Vistry signed a £819 million deal to deliver a mixture of affordable and private rental units to a pair of companies managed by Blackstone, Inc. "We are talking to three others at the moment about large portfolio deals," Stephen Teagle, the head of partnerships, told analysts. The forward order book has already begun to fatten. As of October 20, 2023, it showed £3 billion in contracted revenues for the partnerships unit versus £1.3 billion for legacy operations.

Over the next three years, management says it intends to return £1 billion to shareholders through buybacks and dividends while eliminating net debt. It will accomplish these feats by generating profits and by harvesting capital tied up in its land bank; share repurchases began in December. For a sense of scale, Vistry's market cap stands at £3.3 billion.

Net debt, excluding future landbank payments (£694.8 million), amounted to £328.7 million as of June 30, 2023. In a trading update last Friday, Vistry said that net debt (again, excluding land payments) had fallen to £90 million at the close of 2023 and that, if all goes according to plan, the year-end balance sheet will show a net cash balance.

"If we were, for instance, to buy £1 billion's worth of shares at an average price of £10 and achieve the £800 million adjusted operation profit," Fitzgerald told dialers-in to the Sept. 11, 2023 earnings call, "that would take our EPS to £2.24 against the consensus this year of £0.93, which is a 140% increase." As we go to press, Vistry's shares change hands at £9.60.

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Of course, Vistry faces a host of company-specific and industry-wide stumbling blocks—Nvidia, it's not, needless to say. While Fitzgerald's track record speaks for itself, execution risk looms large in the shift to the partnerships approach. Changing business models is complicated. It involves unwinding the existing landbank and moving personnel from volume housebuilding to broader community development. A decline in building quality or failing to meet construction deadlines could lead to missed profit targets and impair Vistry's brands.

For some, this makes Vistry a show-me story. "While we acknowledge the strategic long-term benefits of [the Countryside] acquisition based on management's track record of successfully integrating Linden Homes in 2019–20," a team of JPMorgan Chase & Co. analysts, led by Zaim Beekawa and who rate Vistry a sell, opined in November, "we continue to see scope for disappointment in management's [earnings] outlook and believe that the ambitious guidance will require proof of delivery in the current macroeconomic context."

Then, too, Vistry needs a healthy U.K. housing market to run down its legacy housebuilding operations. U.K. home prices, like their American counterparts, defied the extreme bearish predictions of early 2023. Despite a rise in five-year fixed mortgage rates to 5.7% last summer from a low of 1.3% in September 2021, U.K. house prices declined by just 1.8% last year.

Expecting a dovish turn by the Bank of England, some British lenders are quoting five-year fixed mortgages at rates below 4% today. "[M]ortgage rates are beginning to ease and the response to our recent Boxing Day campaign has been positive, generating a substantial number of leads for our sales teams," Persimmon plc reported last week, adding that private sales in its order book have increased by around 11% year over year.

As to macro risks, Great Britain is a "small open economy," Ruffer LLP economist Jamie Dannhauser reminds us. "If the U.S. does enter a recession in the next few months, the U.K. will almost certainly follow." And if, in turn, a U.K. slump cut a swath through the job market, residential real estate transactions might plummet and house prices lurch lower.

Besides, a new Labour government might prove unfriendly. True, Keir Starmer, Labour Party leader, has promised to "get Britain building again" and to cut the red tape that stymies new residential development. It sounds bullish, but good intentions aren't enough, as former Prime Minister Liz Truss demonstrated with her badly received budget proposal in 2022 that sent gilt yields soaring and housing activity crashing.

Even well-considered housing policy could have a downside for the partnerships business, analysts fret. "Will others gradually enter this business," Lammin asks, "particularly if Labour comes up with a raft of policies that supports this part of the housing market? You may start to get more competition around margins. How much of margins will you have to give up to partners?"

Most major U.K. builders have faltered in trying to copy the Countryside model. "This concept of working with communities is entirely foreign to the traditional volume housebuilders," Patinkin says while acknowledging that Vistry—which goes to the length of publishing development-specific newspapers for the purpose of keeping all hands informed and engaged—appears deeply committed to succeeding.

The partnership model requires different skills. "The expertise in determining how to design developments that work for mixed tenures on the scale that we have just isn't there with others," Vistry CFO Tim Lawlor tells me. When inexperienced builders enter the fray, they "focus on gross margins and the pricing of private housing as the be-all and end-all. There is a conflict that will exist between gross margins and capital employed, and one of the things that we're prepared to do is take lower margins in order to ensure that we don't have to put loads of capital on our balance sheet."

With seven buys, five holds and four sell recommendations, analysts are divided on Vistry. Not so, the insiders. They purchased 816,000 shares in the past 12 months at a net cost of £6.1 million, and not one executive sold. For his part, Fitzgerald spent £5 million buying 893,348 shares after announcing the Countryside acquisition in late 2022.

The stock trades at 11.2 times estimated 2023 earnings, which are burdened with the costs to integrate Countryside and wind down the legacy housebuilding division as well as with the expected drag of slower home sales this year. The Vistry p/e ratio is in line with that of peers Barratt Developments plc, Taylor Wimpey plc, Berkeley Group Holdings plc and Persimmon, which change hands at an average of 11.1 times. If Vistry can, indeed, perform as Fitzgerald expects it to, generating £2.24 in earnings after returning £1 billion to shareholders and adopting a new business model, the stock can be said to trade at less than four times medium-term earnings.

Of course, businesses that exhibit little cyclicality and generate high returns on capital tend to command large premiums to the market.

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