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Home sweet home

Evan Lorenz writes:

As the virus recedes, house prices advance—or, as the case may be, leap, surge and vault. Now on tap is a survey of the worldwide house-price liftoff followed by a look into UK homebuilder Countryside Properties plc (CSP on the London Stock Exchange). On the latter, in preview, we're bullish.

EZ money and limitless government spending, along with the vogue in working (and napping) from home, all play their role in this global ignition, but real estate, like politics, is ultimately local. In China, where more than one-fifth of housing lies vacant, speculation is the animating force. According to CEIC Data, the average price per square meter of residential real estate soared by 16.3% in the 12 months ended March.

Some Chinese cities are turning to lotteries to ration the number of eager bidders, others are restricting the purchase of second homes. Nationwide, the Communist Party has forbidden developers from expanding if they cross certain "red lines," such as showing a ratio of debt to assets above 70% (*Grant's*, Oct. 2, 2020). According to independent research boutique Plenum, only 11 of the top 100 builders pass muster.

Speculation is in play in Canada, too, where house prices rose by 10.8% year-over-year last month, propelled by a 16.7% jump in Toronto. "It's a housing bubble in Toronto, not a supply squeeze," said the *National Post* last week. Over the past six years, the paper reported, not quite 199,000 new households checked in to Canada's largest city, whereas, over the same span, builders completed more than 230,000 new units. The average price of a Toronto home has spiked to C$1,097,565, from C$567,845 at the end of 2014.

Last week, Prime Minister Justin Trudeau unveiled a 1% annual tax on the assessed value of foreign-owned houses if the government deems them "unproductive." The impost, reports the Toronto *Globe and Mail*, quoting official budget documents, "is designed to ensure non-Canadians either rent or sell their property instead of using it to 'passively store their wealth in housing.'" Vancouver and Toronto have burdened foreign buyers already with property transfer taxes, so far to little effect.

In the United States, home construction has lagged household formation in the dozen years following the Great Recession, a fact that leaves the market short 3.8 million dwelling places, according to Freddie Mac. "It's unlike anything we've seen post–World War II" Richard McPhail, CFO of Home Depot, Inc., told the J.P. Morgan 7th Annual Retail Round-Up Virtual Conference on April 15. "The question will be the persistence of that housing shortage."

Certainly, the bidding is persistent. Last week, Rick Palacios Jr., director of research at John Burns Real Estate Consulting, tweeted out commentary from an April builder survey. Thus, from Salt Lake City: "Most offers are 10+% over ask, that's after raised base prices $10K to $20K+ with each release." And from Riverside/San Bernardino, Calif.: "Anyone walking in is a buyer. There are no looky-loos. Raising prices at an obscene level." The rate of first-quarter new-home sales was the highest since 2006.

No surprise, then, that construction is on the upswing. In March, builders started work on 1.7 million homes (reckoned at an annual rate), the most since June 2006 and a step up from the 1.4 million annualized pace set in February. Yet, even this faster cadence of construction may fall short. Wells Fargo & Co. analyst Deepa Raghavan speculates that demand may hover at a 2.3 million annual unit level for the next decade.

The 2001–06 mortgage bubble notoriously left America with too many roofs over its head, but the United Kingdom entered the 2008–09 financial crisis with a multi-decade shortfall of new homes relative to population growth. Of course, the slump did not improve matters—in 2013, the UK finished fewer new homes than in any year since 1946. In February, the British Broadcasting Corporation pegged the housing deficit at more than 1 million units, which, if adjusted for population differences, would make the UK's need for housing 30% greater than America's. Despite a third lockdown, UK house prices rose 8.6% year-over-year in February.

Reasons for this deficit aren't far to seek. Builders complain about lengthy waits to secure approvals from local councils and the lack of land available for development. The Metropolitan Green Belt, for example, may make London a better city to live in, but it hardly solves the housing problem.

Public policy from the Thatcher era (and long before) constrains supply. Following the Second World War, municipalities built homes for returning veterans. Such local authorities accounted for a large share of construction through the 1970s, but the Housing Act of 1980 stopped them in their tracks. The law gave council estate residents the right to buy homes at a 33%–50% discount to market prices,

Countryside Properties plc at a glance
all figures in £ millions except per share data

	FY 2020*	FY 2019	FY 2018	FY 2017	FY 2016
revenue	£892.0	£1,237.0	£1,018.6	£845.8	£671.3
operating profit	-5.4	170.4	149.3	128.9	87.3
profit from JVs	17.0	44.1	42.0	30.3	19.6
net income	-4.0	168.4	148.6	122.9	61.4
shares (millions)	463.5	450.1	453.6	453.2	450.2
earnings per share	-0.01	0.37	0.33	0.27	0.14
cash	100.5	75.6	47.2	77.4	38.3
debt	2.3	2.2	2.2	0	0
total assets	1,609.8	1,391.9	1,244.1	1,030.5	913.3

* Fiscal year ending Sept. 30.

source: company reports

and it restricted the authorities' ability to reinvest income from sales into new units. But private building has not come close to filling the gap in public construction.

In the cause of affordability, Boris Johnson's government has waived the stamp duty for the first £500,000 of a sale through June 30 and has implemented buyer support initiatives. The Help to Buy program, for instance, allows consumers to purchase a fraction of a home, say 25%, and rent the rest with an option to buy it or to buy another home with a 5% downpayment, with the government supplying a first loss loan of between 5% and 20% of a property's value.

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Which brings us to Countryside, the apple of our eye that takes a market-oriented approach to solving the problem of housing scarcity. Founded in 1958, the company runs a conventional homebuilder division (43% of operating profits in the fiscal year ended Sept. 30, 2020) as well as an unconventional one, known as the partnerships division (57%). Both do business around London, Yorkshire, the South East, Midlands and North West.

The conventional homebuilder buys land, secures permits from local governments and constructs and sells houses. The partnerships division in most cases buys no property but joins with local authorities to assemble a mix of affordable public housing, private rental stock and private homes. The local governments, which manage buildings around 50–70 years old, are typically rich in land but poor in cash. Thus, they usually contribute land while Countryside provides the working capital and the expertise to design and oversee construction. Countryside has entered into agreements to sell private rental stock to investors including the private equity fund EQT A.B. and Goldman Sachs Group, Inc.

Adam Patinkin, founder and managing partner of David Capital Partners, LLC, which counts Countryside as its largest position, calls this a win for everyone involved. "It's a win for tenants, who receive brand new apartments with brand new appliances in brand new buildings," he tells me. "Blind alleys are removed, so crime drops. Community residents also enjoy the benefits of rehabilitated local parks, playgrounds, sidewalks and schools. It's a win for the local authority, as the community is revitalized at little or no out-of-pocket cost while the local authority actually receives cash flow off the project so long as hurdle rates are met." Then, for Countryside, it is a win because they don't have to buy much land.

The last fact is what especially differentiates Countryside. While partnerships earn thinner operating margins than conventional homebuilders do (15% versus 20%), they tie up much less capital and produce much higher returns on capital, on the order of 50% versus 20%. And the business is rapidly growing: Between fiscal years 2015 and 2019, Countryside raised the number of partnership units sold to 4,425 from 1,711.

Strong partnership profits are no accident—contractual language actually guarantees them. Thus, if the economics of a given project fall short, the local council must reduce the cost of land to restore the stipulated return to Countryside. Meeting with the local authorities every 12–18 months, management adjusts the scope of its projects and the mix of its units to maximize returns. This means that, in a recession, the partnerships unit can pivot to more-affordable rental units; in booms, it can shift to pricier ones while ramping up the pace of construction. The group is only exposed to market risk over its private sales volumes for current phases.

You'd suppose that other builders would slavishly adopt the Countryside M.O. Many have tried. One hurdle for a would-be competitor is the period of six to seven years that elapses between bidding on a project and getting the first pound of revenue; completing a redevelopment can take more than a decade. Because it's costly for new entrants to establish a track record, and because, without one, it's hard to win contracts, Countryside has created a kind of moat for itself. Besides, working with public-housing authorities is a skill in its own right. Countryside has proved to be adept at this while others have struggled.

Given the outsized contributions of the partnerships to the parent's results, Countryside should have weathered 2020 better than other public homebuilders. It didn't, and the problem lies less with the quality of the business than with the people who have run it.

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Oaktree Capital Management took the company public in 2016 but left the board and sold its stake in 2018. Ian Sutcliffe, Oaktree's handpicked CEO, retired in early 2020. Iain McPherson, Sutcliffe's successor, the well-respected former chief of the partnerships, lacked experience running a public company. David Howell, chairman of the board, unfortunately has had extensive experience in that line. While chair of Western & Oriental plc (2005–10) and Ebtm plc (2006–08), he oversaw the dilution of the shareholders by more than 70% while presiding over share-price declines in excess of 90%. Activist investors led by Browning West, L.P. did not forget to mention those points last year in pressing their demands for a company-wide overhaul.

Countryside ended fiscal 2019 with net debt, including deferred land payments, of £116.8 million, equivalent to just 13% of shareholders' equity. Unlevered balance sheet or no, however, management opted to issue £250 million's worth of stock at the end of July 2020, thus expanding the share count by 16.6%, the biggest dilution of any public UK housebuilder in the plague year. Of those proceeds, £100 million were earmarked for the balance sheet, the remainder to fund a new fabricated-panel factory and expansion projects in the partnerships business.

Between March 25 and May 11, Countryside went into Covid hibernation, closing sales offices and shutting down construction sites and factories. Availing itself of its purpose-built flexibility, the partnerships division shifted down market, to rental units and affordable homes, but it was still hunkered down when housing demand came roaring back. As a result, Countryside's operating margins in fiscal 2020 dropped by 11 percentage points, to 5.5%—much worse than the experiences of other large, publicly traded British builders, such as Redrow plc (a decline of 8.4 percentage points) Bellway plc (6.5) and Barratt Developments plc (4.5).

Browning West's demands were three: Replace Howell, sell the homebuilding division and install CIO Usman Nabi as a director. Each demand, except for the last, met with Countryside's approval. Howell is on his way out (his last day, in fact, is the very date at the top of this page, April 30), and Rothschild & Co. is out trying to hawk the homebuilding division.

Howell's successor already has won the activist's seal of approval: "John Martin is a former CEO and former CFO of a company called Ferguson plc," Nabi tells me. "It's basically a distributor of plumbing and HVAC supplies, mostly in the United States. He has an amazing track record of around a 500% return while he was at Ferguson. We could not have asked for a more phenomenal sea change from David Howell."

Countryside ended fiscal 2020 with net debt, including deferred land payments, in the sum of £125.9 million, little changed from the year before. A flash preview of the December quarter showed a 17% year-over-year rise in completions, to 1,280 houses, and the company expects to deliver on guidance for 4,053 homes in fiscal 2021, a not unreasonable conjecture since 80% of planned units have been sold already.

The homebuilding business, destined for sale this year, shows a book value of £526 million. Applying the average price-to-book value of 1.7 times what publicly traded comps command would assign it a value of £890 million. The Countryside division has an unusually large land bank relative to sales, which might entice some energetic bidding.

If Countryside applied the anticipated proceeds from the prospective sale of the homebuilding unit to repurchase equity, the share count would tumble by 32%. Based on a backlog of 42,442 units in the partnerships division, Countryside projects the redevelopment unit to sell 8,000 units in 2023, up from 4,425 in 2019 and 3,213 in 2020. Assuming the company earns a 15% operating margin on those sales and a 19% statutory corporate tax rate is applied, Countryside would trade at a highly provisional 9.8 times 2023 earnings—after the yet-unconsummated spinoff and the contemplated share buyback.

Homebuilders, which earn a return based on the land in which they invest, typically trade at a multiple of 1.5–2.0 times book value. In contrast, rapidly growing, capital-lite companies like Countryside's partnerships division commonly change hands at more than 20 times earnings. Of the eight analysts who cover Countryside, five say buy and one says sell. Notably, the current share price of £5.27 is above every price target but one, as analysts, for the most part, still use mechanistic price-to-book multiples to value the stock.

To the one dissenting bearish analyst, one might add the Countryside C-suite itself. Over the past 12 months, insiders have sold a net 213,993 shares for proceeds of £840,513. Past time for a new broom.

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