Redwheel Global Horizon Equity

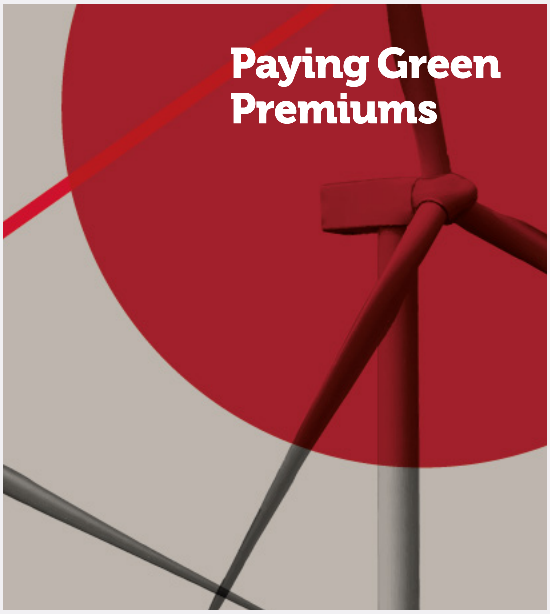
Global Musings

Volume 10

Executive Summary

- As many economies head towards credit cold turkey, this piece explores sectors and holdings in the Redwheel Global Horizon portfolio and how they are responding to changing market dynamics and the broader political environment.
- At the heart of the team's approach is the belief that higher returns on capital attract more capital to lucrative pursuits and lead to a normalisation of returns. In this piece, the team highlights sectors where they perceive supply is increasing, inflationary pressure diminishing and returns on capital are likely to deteriorate.
- Financials have been an area of strong alpha generation both at a sector and portfolio level. However, the team believe their holdings in the sector are significantly undervalued and highlight where they believe current risks are overly discounted in current share prices.
- Within the banking sector, the team assesses the pros and cons of disruptors versus incumbents and their preference for banks with significant economies of scale and that invest heavily in technology.
- Will the private/public equity pricing gap narrow as the pass the parcel of assets among private equity firms is challenged in a tighter debt market? This may create acquisition opportunities for publicly listed companies, previously priced out by private equity when money was mis-priced and plentiful.
- The piece also highlights ESG pressure in the public equity arena potentially making delisting more attractive for companies and the important role of public equity managers in working with companies to build enduring businesses that are fit for the future.

Read more



- This piece assesses the value of green investments and how the cost is likely to be borne among stakeholders.
- Is there a disconnect between positive consumer attitudes towards products with superior environmental credentials and their willingness or ability to pay a premium for them - the "intention-action gap"?
- The piece explores the role of Government intervention and re-framing the pricing discussion as in the electric vehicle market.
- The team discusses one of its holdings, Lennar, and their approach to generating financial returns on environmental investments.
- Within certain industries, the transition to a green business model comes with a readily acknowledged dilution of returns on capital. Here, the team seeks to understand the other benefits that may come with that transition and provides insight into BP and how the team views the potential benefits of the firm's green transition.
- The majority of companies the team has engaged with have not been confident that their customers will pay a green premium without the cost being offset elsewhere. Governments will likely be called on to provide further subsidies and tax incentives for greener investments with the potential risk of adjusting the global competitiveness of domestic businesses either for the better or worse.

Read more

Homebuilders – Supply-side and Affordability Both Sides of the Atlantic:

- This piece showcases two homebuilders, Lennar and Vistry, held in the Redwheel Global Horizon portfolio. The team explores how strong underlying supply-side support and how these businesses should be considered as efficient manufacturers rather than speculative investments on house prices.
- The team's analysis of the US housing market shows how different supply dynamics are compared with the Global Financial Crisis, highlighting a supply shortage rather than the excess supply built up pre-crisis. They highlight a similar picture in the UK.
- As land purchasing slows dramatically, the sector usually generates significant cash thereby providing the fuel for the companies to invest counter-cyclically.
- The team concludes that Lennar and Vistry's ability to generate cash for shareholders across all stages of a market cycle is arguably being underappreciated.

  Read more

Louise Keeling, Portfolio Manager and Head of Global Horizon Equity Team

Louise Keeling is the portfolio manager of the Global Horizon Equity strategy at Redwheel. She has 26 years of experience in investment management and research. Louise started her career on the Bank of England Graduate program from 1996 to 1998. Upon completion, she moved into fund management, working at Clerical Medical (later known as Insight Investment) as a Global (ex UK) healthcare analyst. Louise subsequently moved on to the US desk where she was initially given a portfolio of $1 billion to manage in a generalist US fund. On the strength of her performance, she ended up with sole responsibility for the $4 billion US equity business.

In 2006, Louise joined Marathon Asset Management as Global Portfolio Manager. Under Marathon's multi-counsellor model, portfolio managers are allocated a portion of global assets and given full discretion with no analytical support. Louise spent her first year at Marathon becoming familiar with existing investments and markets that were new to her. In March 2008, with the launch of Marathon's New Global Fund, she was given sole responsibility for a sub-portfolio with an unconstrained global mandate.

Louise joined Redwheel in April 2013 to launch the global long only equity strategy. At Redwheel she invests in the same manner as during her time at Marathon, focusing on long-term investment opportunities, the capital cycle and the alignment of shareholders' and executives' interests.

COLD TURKEY

AHEAD OF THE HOLIDAYS

Years of excessively easy monetary policy are currently being unwound, leading to higher interest rates. Putin's attack on Ukraine and the resulting increases in commodity prices, particularly in European energy, have amplified the negative impact of a tightening policy. Central bankers' paths of least resistance have clearly pivoted, from keeping policy loose as the global economy faced pandemic uncertainties, to battling inflation. However, the narrowness of central bankers' remits is causing tensions with many elected politicians. The former is focused on controlling inflation and maintaining financial stability whereas the latter are more focused on re-election and therefore economic activity and electorate financial health. Weaning the global economy off unprecedented levels of stimulus was always going to be a challenge and the effectiveness of policy is likely to depend, in part, on whether politicians and central bankers are agreed on the amount of pain they can stomach as countries go through credit cold turkey.

At the heart of our approach is the belief that higher returns on capital attract more capital into lucrative pursuits and lead to a normalisation in returns (and similarly Returns On Invested Capital tend to improve for the remaining participants where capacity is being removed). For example, the flow of money was very clear during the pandemic in the semiconductor sector. With supply constrained and demand buoyant, supernormal profits encouraged commitments to add capacity. The political will to have semiconductor capacity within a country's own border has also escalated. Having experienced chip shortages during the pandemic, and rising geopolitical tensions, the risk of being held hostage by other nations through access to semiconductors is no longer deemed acceptable. Consequently, governments are encouraging local investments into chips (and energy). We remain of the view that the profit margins of semiconductor manufacturers are in the process of normalising down and we continue to prefer semiconductor capital equipment manufacturers i.e. the providers of the tools. The fund continues to hold a stake in the semiconductor equipment manufacturer, Lam Research (LRCX). The business is more resilient (relative to new capacity) because it benefits from a strong market position in lithography and has over one-third of its revenues from servicing its installed base. Another name we hold in the portfolio, Taiwan Semiconductor (TSMC), which operational and scale advantage over its peers so is seeing stronger demand than its peers as it focuses predominantly on leading edge chips. Nevertheless, it is not immune to lower industry demand, and we are expecting the company to see a normalisation of gross margins and continued elevated investment levels until 2024 as it expands its operations outside of Taiwan at the request of its customers. We continue to believe that the competitive advantages of TSMC are significant and should be hard for others to replicate however deep their pockets. For context, TSMC will spend around $36bn in capex[1] this year alone versus the entire US Chips Act having a budget of $52bn[2]. The easing of chip supply constraints should also release production bottlenecks from medical devices to auto production and moderate the price of some components and thereby overall inflation.

[1] TSMC 3Q2022 earnings call 13.10.2022
[2] whitehouse.gov/briefing-room/statements-releases/2022/08/09/fact-sheet-chips-and-science-act-will-lower-costs-create-jobs-strengthen-supply-chains-and-counter-china/

Photograph by Alexander Schimmeck

Energy self-sufficiency has also jumped up the political agenda. The Global Horizon approach focuses heavily on supply side economics, so we have found the energy sector interesting recently. We had largely shunned, the sector until late Spring 2020, due, in our view, to historically poor capital allocation such as increasing investment at the top of the cycle to only reverse course at the bottom. However, the penny finally dropped with oil and gas companies that most shareholders want a more disciplined approach to capital investment and higher shareholder returns.

"We continue to believe that the competitive advantages of TSMC are significant and should be hard for others to replicate however deep their pockets."

The significant volatility in oil and gas prices since the Russian invasion of Ukraine is interesting as there has not been a significant reduction in oil production. Rather, Russian oil has been sold to friendly nations at discounts. Consequently, there is more friction in the system rather than a structural shortage of oil. Gas is more complex given the need for infrastructure to already be in place to offset the disruptions to Western Europe supplies. Our holding in Baker Hughes is well placed to benefit from greater investments in nations diversifying their energy needs given the company's strong market position in LNG compressors. In addition, as a service company, it should benefit from higher production levels in

North America and the Middle East over the coming years. The current consensus is that the supply additions, in response to higher commodity prices, should be moderate. If that proves wrong, then Baker Hughes should generate higher profit and cashflow. The current energy crisis, and the varied reliance on Russia for energy across the continent, highlights the complexity of the ECB's task as it sets a single monetary policy for a broad church of economies with differing inflation experiences.

"We expect competitive pressures to potentially moderate for banks and the profitability of the sector is no longer being undermined by monetary policy."

Despite Financials being an area of strong alpha generation this year at both a sector level and in the Global Horizon portfolio, we continue to believe that the portfolio's investments in this sector are significantly undervalued, given the more normalised interest rate environment. Banks are benefiting already from lending rates rising faster than deposit rates thereby creating a positive spread and rising Net Interest Margins. Mr Market appears cautious around the credit outlook but with high capital ratios and rapid cashflow generation, the risk appears to be overly discounted in current share prices. Indeed, some normalisation of credit defaults rates could be a positive as Neobanks and alternative credit solutions such as Buy Now Pay Later providers have not had their credit underwriting skill tested yet. Banking is easy when there are no defaults! Consequently, we expect competitive pressures to potentially moderate for banks and that the profitability of the sector will no longer be undermined by monetary policy.

We spend considerable time debating the barriers to entry of businesses and the benefits of starting with a 'blank' sheet of paper. Within banking, a new entrant usually has a significant technological advantage versus incumbents who normally have a cat's cradle of systems plugged together because of acquisitions through the ages. This can leave incumbents less nimble and potentially with inferior real-time data. On the other hand, incumbents have survived previous cycles, are more experienced underwriters, have existing client relationships, economies of scale and lower capital costs. On balance, we have found the latter outweighs the former. We have a preference for banks with significant economies of scale and who invest heavily in technology, as this enables them to understand their exposures better and to close the technological gap relative to start-ups. Indeed, we have seen large incumbents such as JPMorgan and BBVA enter new markets as Neobanks and harness the benefits of both a start-up and its incumbency.

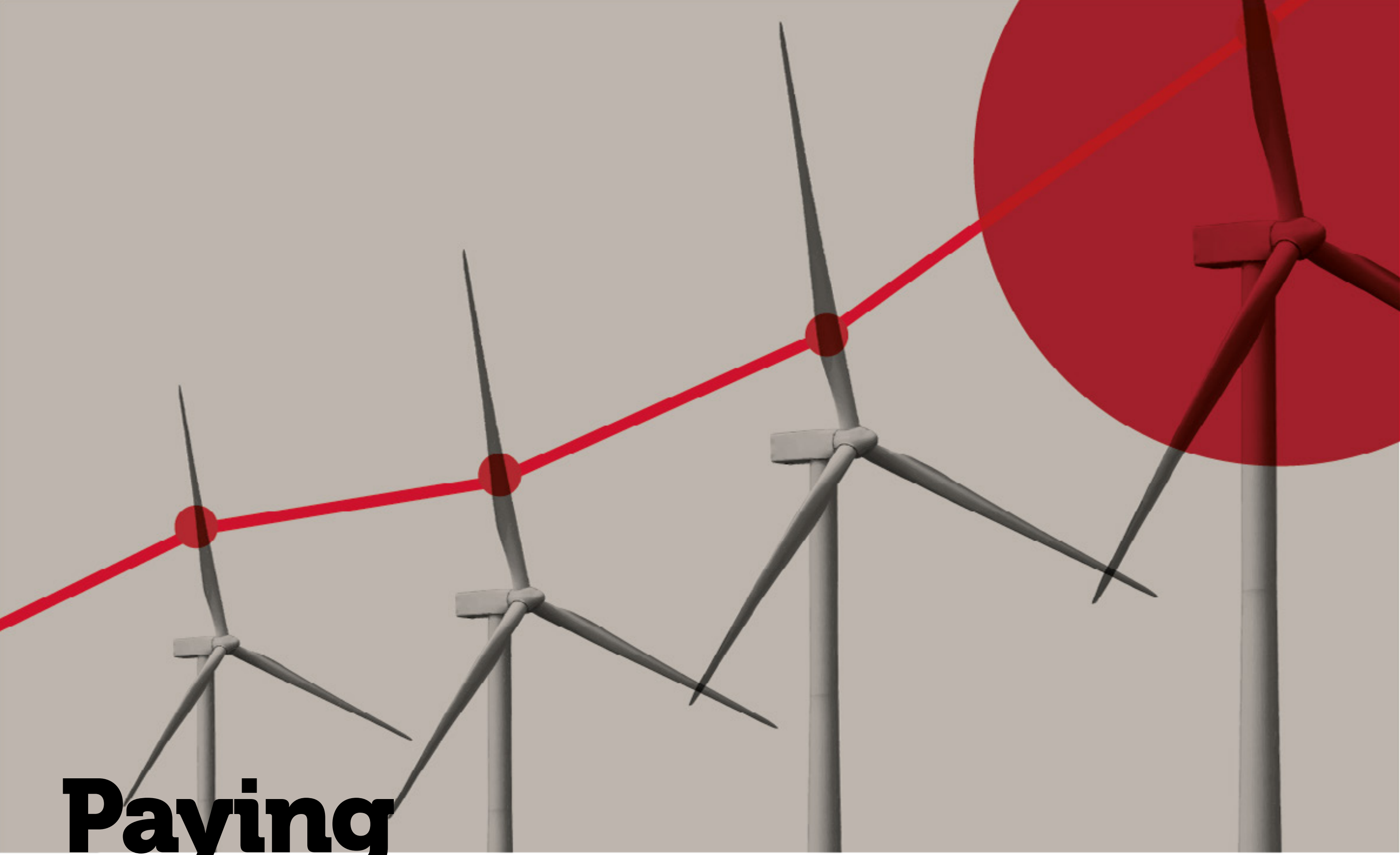
Photograph by Sam Trotman

As the cost of financing rises, credit is tightening and potentially opening acquisition opportunities for publicly listed companies who were being priced out when money was plentiful. Furthermore, it may lead to private market valuations coming more in line with public market comparables. Over recent years private equity has benefited from significant flows and cheap funding leading to more frequent private equity to private equity transactions. This raises the specter of a significant valuation disconnect between the prices of businesses held within the public and private domains. The valuations at which transactions occur are opaque but the absence of industrial buyer transactions or public equity IPOs suggests that higher multiples are being paid in the private equity space than elsewhere. The incentives for private equity funds are to deploy cash and to gain a carried interest i.e. profit on their holdings. This is easier to achieve if the private equity industry is playing pass the parcel with assets and they are marking each other's homework. In addition, higher rates diminish the financial benefits of having a more geared balance sheet. It would also seem logical that the incremental contribution from the third or fourth private equity owner would be smaller than the first. ESG pressure in the public equity arena could also be a push for companies to go private and benefit from the opacity offered by being private. This is a risk which public equity managers need to be cognisant of and ensure they are working with managers of businesses to build enduring businesses which are fit for the future.

Finally, labour is an area where higher pricing is persisting but workers still have seen a degradation of their purchasing power. Consequently, heated wage negotiations and strikes are becoming more common place. Declining consumer purchasing power is likely to be a dampener to economic activity but embedding current higher inflation levels into multi-year wage deals risks rendering firms uncompetitive. There are also increased incentives for workers to return to the workforce in an inflationary environment as the real value of their savings is eroded. A redistribution of workers within the economy is also underway as those who flooded into the technology space in recent years, are now subject to cost cutting. It seems very likely that worker shortages and their contribution to higher inflation will moderate as labour supply is reignited and redistributed.

Overall, prices continue to signal where capacity should move to, and people and capital are responding. This suggests to us that inflationary pressures are moderating as markets continue to respond to excesses and deficits. Nevertheless, consumers and enterprises look likely to have plenty of cold turkey this holiday as the economy adjusts to a more normalised cost of capital.

Key Information



Paying for Green Premiums[1]

The need to tackle climate change is well versed, however transitioning the global economy towards lower carbon production requires capital investment and behaviour change which can be inflationary in the near term. Typically, "greenflation" is viewed through the lens of certain commodity prices, notably cobalt, copper, lithium and nickel, which are required in electric vehicles, batteries and renewable power generation. However, the cost increases associated with better environmental outcomes are broader than that and are being incurred by all businesses, raising the question: which stakeholder is willing to pay for that additional cost?

We engage with companies to better understand the levers within their control to improve their environmental performance, and how those decisions fit within their broader capital allocation framework. The scale and pace at which they make environmental investments is likely to be a function of the expected financial return on the investment; the expected environmental return on the investment (i.e. size of environmental benefit for every dollar spent); the opportunity for risk reduction (notably reputational, regulatory, and stranded asset risks), and to develop business capabilities which may deliver a competitive advantage now or in the future. All these factors contribute to our discussions with companies on the appropriate pace of environmental investments. In this piece, we explore some of the incentives and trade-offs that can impact that decision making.

To understand the impact of these environmental investments on financial returns we must consider which stakeholder is being expected to pay for them. Some industries benefit from government subsidies or tax exemptions, which socialise the cost of environmental improvements. In the absence of government support, the change in environmental credentials might be expected to command sufficient pricing power that the consumer is financing the investment, usually involving them paying a green premium (a higher price representing the cost differential for this "cleaner" product). If there is an unwillingness or inability for the government and/or customer to meet the additional costs, then it may represent an implicit charge to other stakeholders, or to equity holders in the form of lower margins or lower returns on capital.

The consumer's willingness to pay a "green" premium can be thought of like a price elasticity curve where a company is considering the slope of higher prices it could charge for an increasingly green product, and how this compares to the associated increase in costs. The challenge for many businesses we interact with is that in their experience, which is supported by industry research[2], there is a disconnect between positive consumer attitudes towards greener products and their willingness or ability to pay a premium for them. This is known as the "intention-action gap" – the difference between what we say we will do and what we actually do. In 2020, research firm Globescan conducted a global sustainability survey[3] across 27 markets of c.1000 adults per market. The results showed that 73% of respondents agreed with the statement that "I want to reduce the impact that I personally have on the environment by a large amount". However only 25% had "made major changes to their lifestyle in the past year" to be more environmentally friendly. This disconnect can have implications for the pace at which companies choose to allocate capital towards a greener business model.

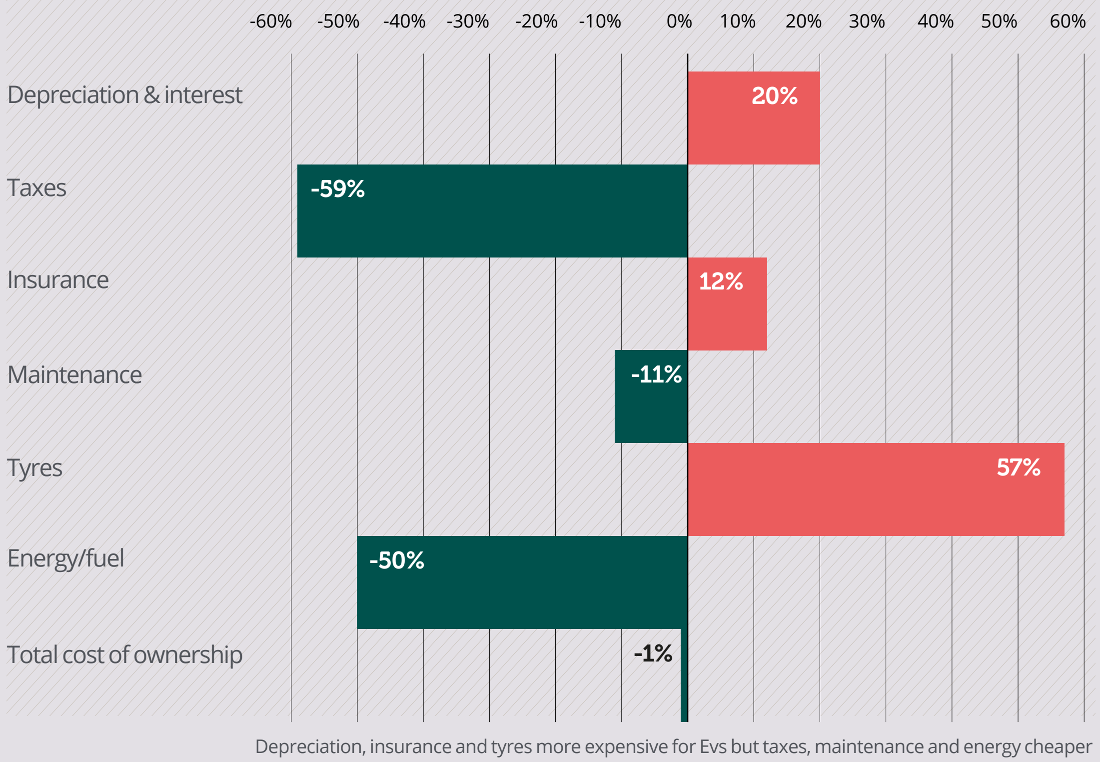
[1] Introducing the Green Premiums | Bill Gates
[2] How much will consumers pay to go green? | McKinsey
[3] Healthy and Sustainable Living Highlights Report 2020 | GlobeScan

"There is a disconnect between positive consumer attitudes towards greener products and their willingness or ability to pay a premium for them."

The magnitude of the green premium in absolute terms, and as a percentage of selling price, is likely to impact the consumer uptake of the greener option. The price trend of the incumbent, "dirtier" alternative is also relevant. Rises in oil and gas prices, or more explicit costs being introduced on carbon, could increase their cost and therefore narrow the green premium for more sustainable products. For example, the introduction of carbon pricing within Europe is impacting the behaviours of European cement companies. As this additional carbon cost is applicable to all producers, it should lead to industry-wide price increases for higher-carbon cement varieties. Plans for a Carbon Border Adjustment Mechanism for imports of cement into the European Union should ensure all producers incur this new cost line but how effective implementation will be is an unknown. Industry-wide price increases should narrow the green premium of lower-carbon cement varieties. This accelerated shift in demand towards lower carbon cement then creates an improved economic incentive for additional investments into lower carbon clinker mixes or longer-term carbon capture technologies. Notably, Heidelberg has recently announced plans for the world's first carbon neutral cement plant, to be built in Sweden by 2030. If these additional investments and green capabilities become table stakes within the cement industry, it could also serve to squeeze out smaller cement producers unable to make these investments, or legacy dirty capacity where the upgradation costs are unjustifiably high - a potential capital cycle opportunity in the future. The lack of carbon pricing in the US serves to entrench the green premium at a higher level for the cement buyer. It also creates weaker economic incentives for US producers to invest in greener products and production methods unless they come with a clear economic payoff i.e. selling products with lower clinker mixes which increases their cement capacity and tons sold. From their perspective, given limited regulatory pressure or consumer demand for lower carbon products, they can rationalise deferring investments further to the future, at which point the technology involved may have become more commoditised. This highlights why the Net Zero Owner Alliance recently released a position paper advocating for strengthening carbon pricing regimes[4], to send clearer market signals, to better incentivise changing behaviours and capital allocation decisions, and minimise price distortions.

Some companies are also seeking to increase consumer willingness to pay a green premium by re-framing the price of the product through a "total cost of ownership" narrative. For example, although the upfront cost of electric vehicles (EV) remains at a significant premium to internal combustion engine (ICE) vehicles, the difference is much narrower over the total cost of ownership (TCO) because of lower fuel costs, lower maintenance costs, and government support in many markets. The analysis in Figure 1 below shows the difference in the TCO between a Volkswagen Golf and a Volkswagen ID3, similar sized ICE and Electric vehicles respectively, as an average across 22 countries[5]. An pink bar to the right reflects a cost for the EV being more expensive, with green bars representing items where there is a lower TCO for an EV.

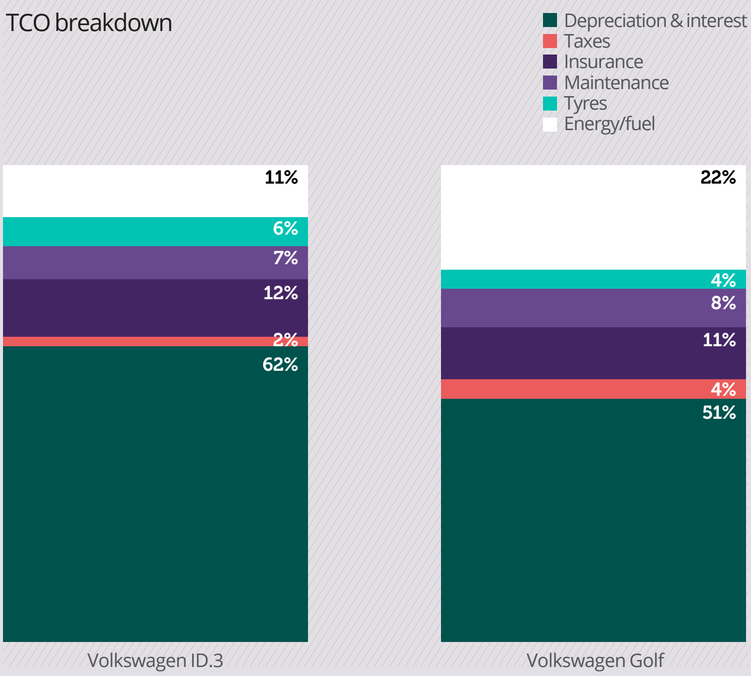
Figure 1: The difference in TCO between a Volkswagen Golf and a Volkswagen ID3:



Source: Total cost of ownership: How electric vehicles and ICE vehicles compare. Leaseplan February 2022
The information shown above is for illustrative purposes.

[4] NZAOA_Governmental-Carbon-Pricing.pdf (unepfi.org)
[5] Total cost of ownership: How electric vehicles and ICE vehicles compare | LeasePlan

Figure 2: Total cost of ownership breakdown of a Volkswagen Golf and a Volkswagen ID3

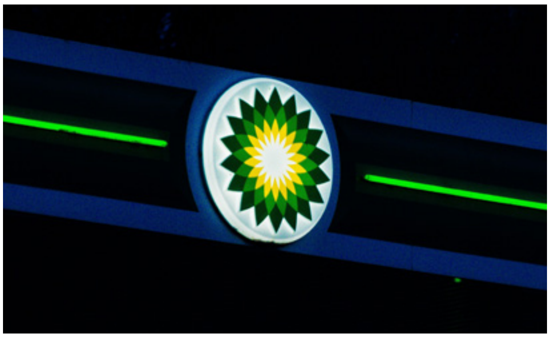


Source: Total cost of ownership: How electric vehicles and ICE vehicles compare. Leaseplan February 2022. The information shown above is for illustrative purposes.

The depreciation and interest cost of the ID3 is 20% higher due to the higher upfront purchase cost, which is often how consumers perceive a green premium. Despite this, due to lower ongoing operating costs, the Total Cost of Ownership of the two vehicles is broadly in line. There is also a commercial incentive for Volkswagen and other auto manufacturers to position EVs at a higher price point as there is generally less revenue from servicing and parts over the life of the vehicle, and a desire to recoup the investments which have been made into the creation of EVs. However, the barriers to entry for EVs are significantly lower than combustion engine vehicles and the market is attracting attention from new players which suggests that the pricing of EVs could come down as supply increases. Furthermore, Euro 7 and similar regulations which are imposing significantly more stringent emissions standards on combustion engines are adding thousands to the development costs of smaller vehicles potentially rendering them uneconomic for Original Equipment Manufacturers (OEMs) to produce. It will also increase the cost of gas-guzzling performance engines, but the higher price point may be able to absorb the investment.

We have also witnessed some companies structuring their revenue streams in new ways to generate financial returns on environmental investments. Lennar is a leading US homebuilder and is working with third party companies to introduce environmental management solutions into its new-build homes. However, buyers are typically unwilling to pay extra for these additions and would rather spend any extra money on square-footage. For example, consumers have been unwilling to pay a premium for the installation of water management solutions which divert wastewater from taps in the house to sprinkler systems in the garden to reduce water usage. However, because these solutions[6] reduce the utility intensity of the newly built housing community, if Lennar deploy the water management solution by default, the municipality is likely to approve a higher density of homes on a particular land bank, which reduces the land cost per home by at least the cost of deploying the tool.

In instances where a transition towards a greener business model comes with a readily acknowledged dilution of returns on capital, we seek to understand the other benefits that come with that transition, such as the size of environmental improvements that are expected, the opportunity to reduce business risks, and changes in the shape of the return profile. An example is BP, where we are owners and are supportive of the company's efforts to transition into an integrated energy provider. This includes the planned disposal of $25bn of upstream oil and gas assets over 2020-25 and a target of 50GW of installed renewable generation capacity by 2030 (for context, Ørsted's 2030 target for generation capacity is also 50GW, which is a dedicated renewables GenCo with $45bn enterprise value). The prospective returns for BP's upcoming renewable generation capacity, at 5-6% unlevered, compare unfavourably to the returns on the existing upstream oil and gas business. However, unlike the existing cyclical oil and gas assets, the renewable assets potentially offer a defensive and utility-like long-term earnings stream. This characteristic allows BP to utilise leverage, to generate levered returns of 8-10% on its renewable portfolio[7]. Although, even when levered, this portfolio transition should result in a lower blended return on capital for BP, it should also result in a more diversified, longer duration and less cyclical earnings stream, with lower stranded asset or regulatory risks. This internal environmental transition for companies can also be a source of alpha for investors. Academic research indicates that there is a significant alpha generation opportunity from companies whose ESG credentials are improving due to investments in material sustainability issues (Khan et a[8]), and research indicating that portfolios built of companies with improving ESG scores outperformed both the Index and portfolios of companies with high ESG scores (Nagy et a[9]).



Photograph by Simon Cheung

We have always engaged with management teams to understand their capital allocation lens. We believe that management need to have clarity on how the business is going to remain relevant and able to compete in the years to come. Managing the environmental risks of their business is just one aspect of this. So far, the majority of businesses we have spoken to have not been confident that their customers will pay a green premium without there being a cost offset elsewhere e.g. better energy efficiency. Governments are likely to be called upon to use further subsidies and taxes to incentivise greener investments. However, these risks adjusting global competitiveness of domestic businesses either for the better, which may be deemed state support and anti-competitive, or for the worse due to higher cost bases. In the meantime, making better products which also have environmental benefits appear the most likely way to get paid for your efforts.

Key Information

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part. Forecasts and estimates are based upon subjective assumptions about circumstances and events that may not yet have taken place and may never do so. The statements and opinions expressed in this article are those of the author as of the date of publication, and do not necessarily represent the view of Redwheel. This article does not constitute investment advice and the information shown is for illustrative purposes only.

[6] Direct company engagement with Redwheel Global Horizon team
[7] BP Annual report, page 60: bp-annual-report-and-form-20f-2021.pdf
[8] Corporate Sustainability: First Evidence on Materiality | Harvard Library
[9] Can ESG add alpha? | MSCI

Homebuilders:
Supply-side and Affordability both sides of the Atlantic

The Housebuilding sector should now be tested in its ability to navigate a period of monetary tightening and weakening consumer affordability. The Global Horizon portfolio has investments in two homebuilders, Lennar (LEN US) in the US and Vistry (VTY LN) in the UK. In this piece we discuss the underlying supply side support for the sector, which remains strong; the features of both companies' models which should allow them to continue generating cash across a range of market environments; and how current valuations offer an attractive asymmetry of outcomes for owners.

In years preceding the Global Financial Crisis (GFC), over-leverage and over-investment in the real estate sector led to high residential build rates and a build-up of excess supply in the US housing market (see Figure 1). The market turned and demand deteriorated the excess supply. This was exacerbated by forced selling from owners in negative equity, and led to a severe correction in home prices. The supply side of the market looks entirely different today. The past decade has seen a prolonged period of under-building of homes in both the US and the UK compared to the requirements of demographic growth, household formation and replenishment of old stock[1].This eliminated the supply overhang built up pre-GFC in the US; but then prolonged underbuilding has caused a structural supply deficit (see Figure 1) of almost 5 million homes relative to 122 million households in the US[2].

[1] The Major Challenge of Inadequate U.S. Housing Supply I Freddie Mac
[2] US Census Bureau

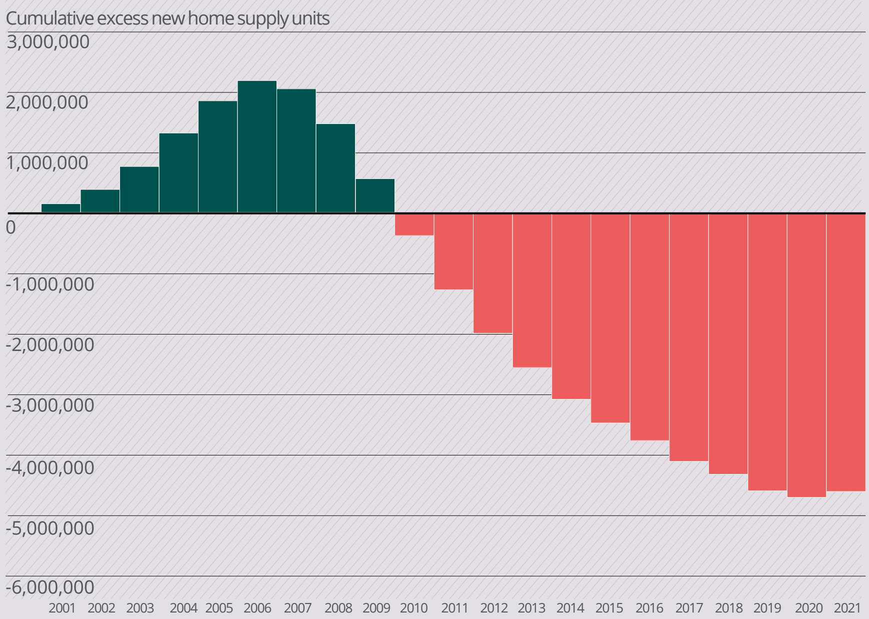
Similarly in the UK, the government has set a target of building 300,000 new homes per year in England to meet the structural demand requirement from new household formation. This target has consistently been missed, with only 216k homes built in 2021. Over the last 10 years (2012-2021), the aggregate effect of missing that annual target has been a total under-build of 1.1m homes[3]. For context, this represents 5% of the 21.4M households in England in 2021[4].

"This backdrop of tight supply combined with a period of low interest rates has helped support profitability for homebuilders over the last decade, as rising prices encouraged greater sales velocity and allowed homebuilders to generate better margins."

This backdrop of tight supply combined with a period of low interest rates, has helped support profitability for homebuilders over the last decade, as rising prices encouraged greater sales velocity, and allowed homebuilders to generate better margins on operational leverage and land price appreciation over the holding period.

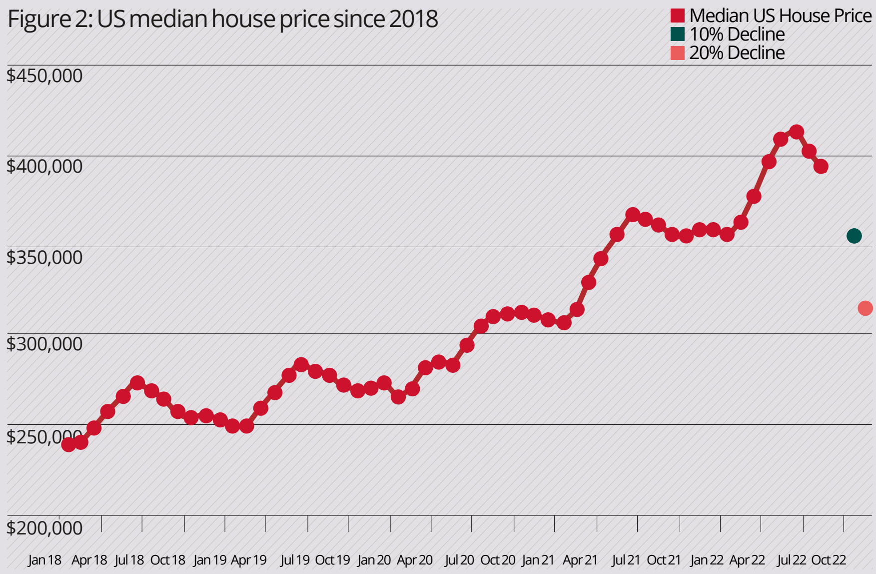
While the supply side of the market remains constrained, rising interest rates are now negatively impacting buyer affordability and demand. The National Association of Realtors maintains an Affordability Index[5], which incorporates home prices, household incomes and long-term mortgage rates to create a housing affordability indicator. The average index value of 150 in 2021 meant that the median US household income was 150% higher than the required level to keep mortgage payments on a median priced home under 25% of the household budget (with an 80% loan-to-value). As house prices have continued to increase in the first half of 2022 alongside rising mortgage rates, that affordability metric has now deteriorated to 102 (red line of Figure 3). Weaker affordability should impact demand. Indeed, homebuilders in both the US and UK are now reporting more price sensitivity among buyers and are increasing the level of promotions to maintain sales rates. House prices are now declining month-on-month but are still at price points higher than at the start of the year (See Figure 2).

Figure 1: Cumulative US housing supply deficit



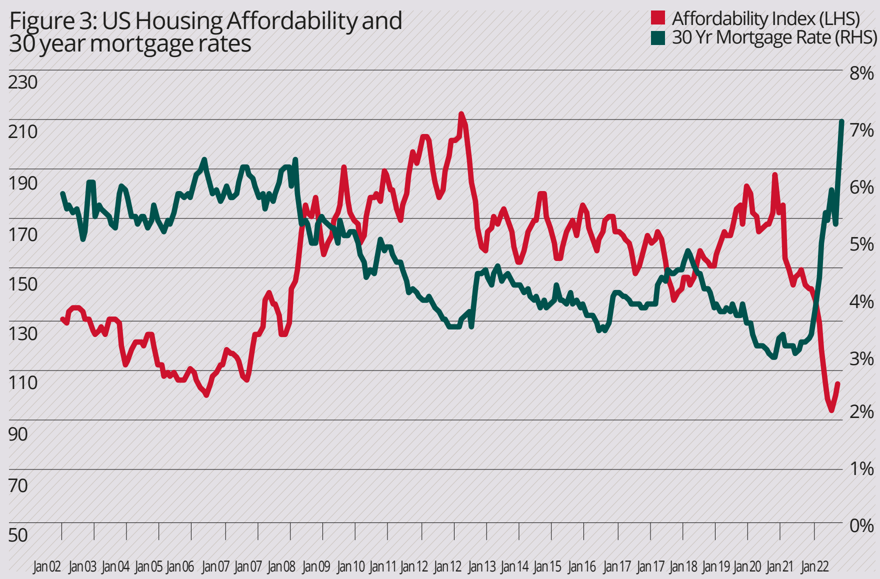
Source: U.S. Census, Urban Institue, PIMCO as of 31 December 2021
Past performance is not a guide to the future

Figure 2: US median house price since 2018



Source: US National Association of Realtors, Bankrates.com August 2022.
Past performance is not a guide to the future.

Figure 3: US Housing Affordability and 30 year mortgage rates



Source: US National Association of Realtors September 2022.
Past performance is not a guide to the future.

[3] Housing supply: indicators of new supply statistics | UK Government
[4] Households in the UK by region | Statista
[5] Housing Affordability Index | National Association of Realtors

Photograph by Josh Olalde

This Affordability Index is a useful heuristic to understand the size of price adjustment that might offset various levels of interest rate change or income growth. For example, if the 30-year US mortgage rate stays at this level and median household incomes grow 15% over a 2-year period; then a 10% drop in house prices would take the affordability index back to 130, while a 20% decline in house prices would entirely offset the impact of this year's increase in mortgage rates. Clearly, lower income growth would require a greater house price adjustment. The interconnectivity of these factors is clear i.e. that higher inflation leads to higher interest rates (based on current monetary policy ethea) but requires higher wages (to maintain purchasing power). If not, then the asset i.e. land price will need to adjust more significantly. However, since we don't know with any precision how severe or protracted any decline in house prices will be, we spend our time understanding how homebuilders allocate capital and adjust their models to the environment.

Homebuilders acquire land (often through options), contract builders to construct homes and sell the house to the end consumer. At the time of purchasing the land, homebuilders make an assumption of the expected sale price of the property, cost to build, required sales and marketing spend, embed a margin for their endeavours and the residual is the amount available to purchase the land. Consequently, the main sources of risk are the end selling prices and cost of producing the home for land which has already been committed to. For any new land purchases, lower house prices will now be embedded (potentially along with higher margins to compensate for the greater affordability uncertainty) and the land price paid, as the residual, adjusted downwards. As such, the shorter the time period between the commitment of capital to purchase land and the sale of the property, the lower the risk incurred by the homebuilder. In buoyant housing markets, the homebuilder typically gains from operating leverage and achieves sale prices above assumption. In softening markets, homebuilders generally need to monetise the existing pipeline of projects to minimise losses/maximise profitability and to replenish cash ready for when the landowners have adjusted their expected prices for the new environment. Homebuilders recognising that they are price takers and monetising their existing pipeline of projects is rational. However, to put new capital to work in land purchases, they need to embed higher margins as a buffer and/or use options for land rather than outright purchases. Well-run homebuilders are efficient manufacturers of houses, not house price speculators.

The most significant cost item for a homebuilder is build cost. Specific to Vistry, build cost was 60% of the sale price in 2021[6]. As the housing market weakens and fewer projects are launched, demand for construction labour weakens and labour rates are likely to ease. Material costs may also soften but the high energy input of cement and steel, for example, adds an additional driver to pricing.

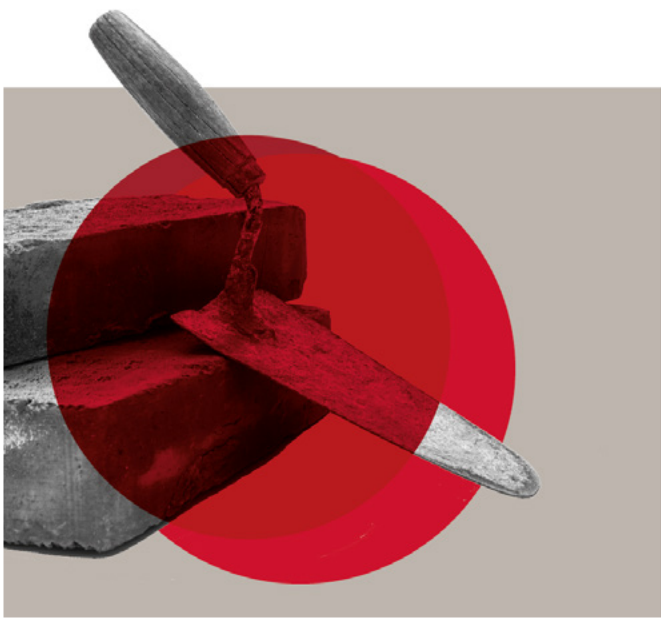
Lennar and Vistry both have business models which allow them to match costs to pricing with greater synchrony, helping them to produce positive cash flows on homes built across the cycle.

Lennar has been gradually shifting its business to a land-light model, where the landbank is owned by third parties and Lennar has the option (but not the obligation) to buy those plots in the future when it is ready to start building. In the August 22 quarter end, these represented 63% of its land plots vs 20% in FY16[7]. So, if the exercise price for a land contract no longer makes sense, Lennar can simply choose to not exercise it. This generally reduces the risk of entering a market downturn with a sunk cost base that guarantees poor profitability or impairments to equity in the coming years.

For Vistry, approximately one third of their profit (growing to half in the coming years) is generated from their Partnerships business[6]. Vistry builds homes for Partners such as local government authorities or housing associations. The Partner typically provides the land, and the price for the finished homes is agreed at the start of the contract with escalation clauses for labour and materials inflation. Locking in a margin at the outset of the build may be less advantageous in a rising house price environment but provides margin support and ability to maintain scale benefits (including relationships with contractors) for the homebuilder in a declining house price environment. Although the margins in this segment are lower than traditional homebuilding, there is also very limited capital being deployed, allowing Vistry to potentially earn Returns on Invested Capital in excess of 40% with much more visibility on future cash flows.

Pre GFC there were over-leveraged homebuilders who chased volumes too aggressively at the top of the market. As profitability deteriorated, many were forced to sell more homes to cover fixed costs and their interest payments. The discounting and promotional activity led to further margin erosion causing a negative spiral on cash flow and leverage. Listed homebuilders in the US and UK enter this downmarket with much stronger balance sheets, reducing the risk of widespread inventory fire sales. Both Lennar and Vistry have spent the last 3 years significantly de-levering their balance sheets. Lennar has reduced its net debt from $9.8bn in FY18 to $3.3bn, while Vistry now has a net cash balance sheet[6 7].

[6] Vistry company reporting 2021 and 2022
[7] Lennar company reporting 2021 and 2022



"At current share prices, we feel the ability of Lennar and Vistry to generate cash for shareholders across all stages of a market cycle is being underappreciated."

Both companies enter a downturn from a position of strength, and with an ability to invest counter-cyclically. That has allowed them to use profits this year to repurchases shares, taking advantage of the de-rating of the sector. In addition to buying its own shares, Vistry is acquiring a distressed peer, Countryside Properties ("Countryside"), which has been under pressure from its shareholders due to lacklustre operational performance and has recently seen its CEO step down. We expect this to potentially yield significant operational cost synergies, while increasing Vistry's exposure to the defensive and asset-light Partnerships segment.

Our homebuilders have an additional lever that they can pull to manage cash flows in a downturn – flexing the level of re-investment into the land bank. Vistry[6], for example, has an owned landbank of 30.6k plots. This is enough for them to build and sell homes for 4.6 years at current build rates. Although the cash for many of these plots has already left the business (except for outstanding land creditors), the cost will only be recognised as an expense in the P&L when the completed homes are sold. If Vistry stops or slows the pace of re-investing in its land bank the cashflow generated on each home sold would be the accounting profits plus the land cost per plot (£49k on average). So, under a scenario where the market deteriorates to the extent that Vistry is building and selling homes on its land bank at a 0% operating margin (which would be a 15% house price decline from current levels with no reduction in costs), and they make no re-investments into new land, the business could generate c.£1.5bn of cash by monetising its existing land bank. This excludes any contribution from their asset-light Partnerships business which generates c.£100m of free cash flow per year. When the Global Horizon team bought additional shares in Vistry in September, the enterprise value of the company was £1.1bn. The Vistry management team has said that if the returns from repurchasing shares, whereby they are acquiring an additional stake in their existing land bank at a discount to its market value, continue to look more attractive than the returns for purchasing new land, then cash will be utilised for additional buybacks.

Lennar offers a similarly attractive range of outcomes from the current share price. The company expects their average selling price in 4Q22 to be $475-480,000. If we assume a -10% decline from that level in 2023 while build costs continue to grow +5%, the gross margin would be squeezed from 28% to 18% (and assumes that the burden is borne wholly by the company rather than shared with landowners due to the short time frame). The negative operating leverage on the fixed central costs of the business would then cause net profit to fall by -43% to $2.9bn and returns on equity would fall from 19% to 10%. With a current Enterprise Value of $25bn, the company is still only trading on 9x its annual cash profits under this scenario. If house prices fall by a more moderate 5% next year, the company's current enterprise value is just 6.5x its annual cash profits[7].

Rising interest rates and weakening buyer affordability are impacting demand within the residential real estate sector. Despite knowing this, we must be careful to avoid the pitfalls of recency bias – where we expect similar consequences for today as the last real estate downturn, without acknowledging the changed fundamentals. The supply glut from 2007 is now replaced with a supply deficit; over-leverage at developers and homeowners is replaced by well-capitalised homebuilders and an average loan-to-value ratio for households 20% lower than a decade ago[8] in the US. At current share prices, we feel the ability of Lennar and Vistry to generate cash for shareholders across all stages of a market cycle is being underappreciated.

Key Information

[6] Vistry company reporting 2021 and 2022
[7] Lennar company reporting 2021 and 2022
[8] US mortgage market statistics | lendingtree.com

And finally...
the ultimate inflation risk?

"The smarter we make the A.I., the less it wants to do our jobs."

Contact us

Please contact us if you have any questions or would like to discuss any of our strategies.

invest@redwheel.com | redwheel.com

Redwheel London
Verde
10 Bressenden Place
London SW1E 5DH
+4420 7227 6000

Redwheel Miami
2640 South Bayshore Drive
Suite 201
Miami
Florida 33133
+1 305 602 9501

Redwheel Singapore
80 Raffles Place
#22-23
UOB Plaza 2
Singapore 048624
+65 6812 9540

Unless expressed otherwise, all opinions in this document are those of the Redwheel Global Horizon investment team, as at as at 15 December 2022.

redwheel