The UK Forest Market Report

The Housing Market: A Temporary Lull

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The health of the UK's housing market is an important bellwether for the strength of demand for sawmills' finished product, sawn wood. The UNECE's Timber Market Statement for the UK has consistently emphasised this fact. In 2017, it noted that "*the construction industry plays a vital role in driving sawn softwood consumption.*" Its 2018 report reiterated the point, stating: "*Demand within the construction industry remains a large influence on the timber market within the UK.*"

The mechanics of the timber supply chain neatly illustrate the logic. Activity levels among joiners, builders, roofing specialists, landscapers etc depend heavily on the volume of construction projects, both on new houses and on the maintenance and improvement of existing homes. These trades comprise the core customer base of builders' merchants, such as Travis Perkins, Buildbase and Jewsons, who themselves constitute the dominant client group of the UK's sawmills, such as James Jones, Glennons and Pontrilas.

The Bank of England's decision to raise interest rates from 0.25% to 0.75% through late-2017 and 2018, by determining demand in the housing market, also shaped trends in the timber market through late-2018 and 2019. As the principle influence on borrowing costs, as a key determinant of future cash flow values and as the benchmark against which the viability of development projects is gauged, the level of interest rates is a pivotal influence on construction activity.

To provide some background context to the current situation, the Bank of England's rapid markdown of interest rates in the aftermath of the Financial Crisis, from 6% in late-2007 to 0.5% in March 2009, triggered a powerful upsurge in the UK's housing market. By reducing mortgage rates and raising the affordability of a new home, it propelled house prices upwards. Rising property prices then provided a powerful incentive both for house builders to develop their vacant land sites and for homeowners to repair, improve or expand their homes.

As *chart 1* illustrates, the value of housing-related investment has surged over the past decade. Between 2010 and 2019, the quarterly value of private sector housebuilding tripled from roughly £3bn to over £9bn. Meantime, expenditure on repairing and improving the UK's existing housing stock rose 50% from £5bn to £7.5bn.

However, with higher interest rates lifting mortgage costs through summer 2018, homebuyers' ability to afford ever-higher prices was undermined. As a result, through autumn 2018, clouds started to emerge across the once-buoyant trends in the housing industry.

According to the Office for National Statistics, house prices in London declined 0.3% YoY in September 2018 while UK-wide prices rose just 0.6% YoY

Chart 1: Quarterly Value of Housing-Related RMI and Private House Building, 1990-2019 (£mn)

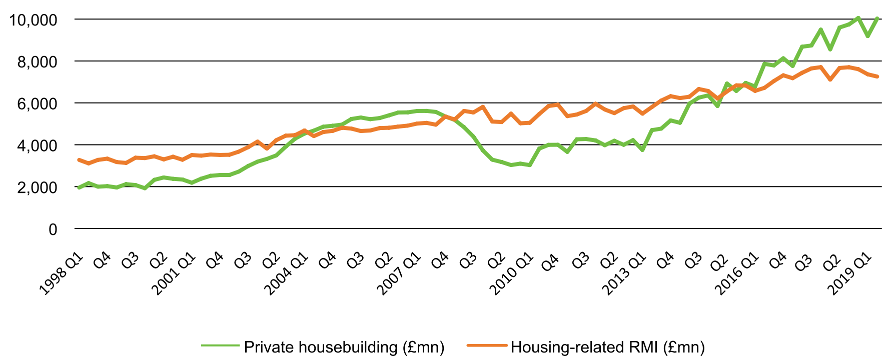
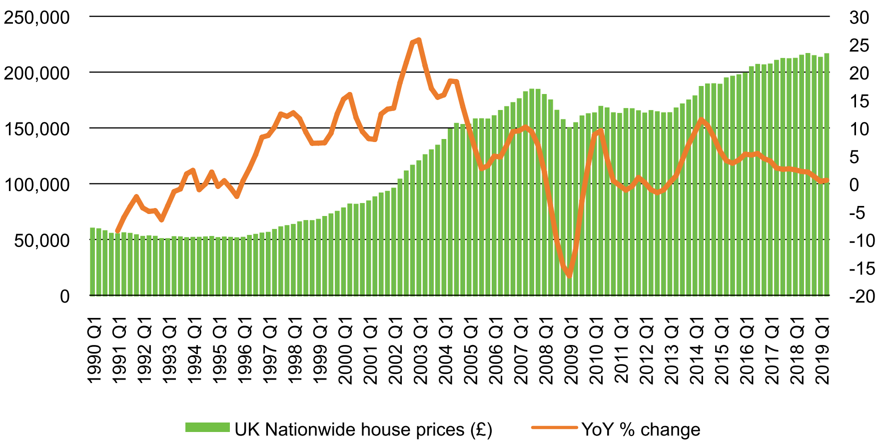


Chart 2: Average UK House Prices, 1990-2019 (£)



in H2 2018, against gains of over 4% through 2015, 2016 and 2017 (see *chart* 2). In October 2018, the Construction Products Association (CPA) also reduced its growth forecast for 2019 from 2.3% to 0.6% citing, among other things, concerns for housing starts growth.

However, the real-world consequences of these early-warning signs had yet to ripple back up the supply chain. Property developers continued their housing projects: house building in the private sector rose 6% YoY in Q4 2018. In October 2018, David Thomas, Barratt Developments' CEO, reported "*A good sales rate, a healthy forward order book and wide availability of attractive mortgage finance.*" Grafton Group, which owns Selco and Buildbase, the builders' merchants, also saw sales grow 8.7% YoY in H2 2018 at its UK merchanting business.

Strong trends in the housing market were also ensuring buoyant demand for the MDF and OSB panels produced by the particleboard makers, who accounted for 11% of UK delivered roundwood volumes in 2018. In November 2018, during a conference call to discuss Norbord's Q3 2018 results, Peter Wijnbergen, the company's CEO, reported "*another excellent quarter*" with "*accelerated demand growth in our core UK market.*" Unfortunately, as winter receded and spring heralded the resumption of building activity, the consequences of rising interest rates meant the CPA's downbeat forecasts for 2019 demand trends proved accurate. According to Nationwide, house prices were falling 2.3% and 1.4% YoY across London and the south east respectively through H1 2019 while, across the UK, they rose just 0.5% YoY.

This stagnation was not only discouraging homeowners from undertaking improvements to their homes (see *chart 3*), it was also discouraging private sector housebuilders from embarking on new projects (see *chart 4*). The consequences of this deceleration in the housing market were clearly apparent in the results of the listed builders' merchants and housing developers i.e. the sawmills' main customers.

Chart 3: Housing-Related RMI Spending vs UK House Prices, 1999-2019 (YoY % change)

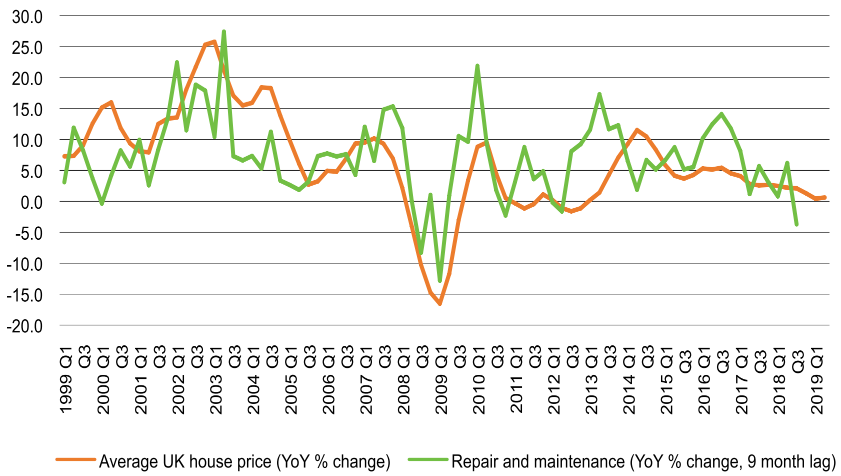
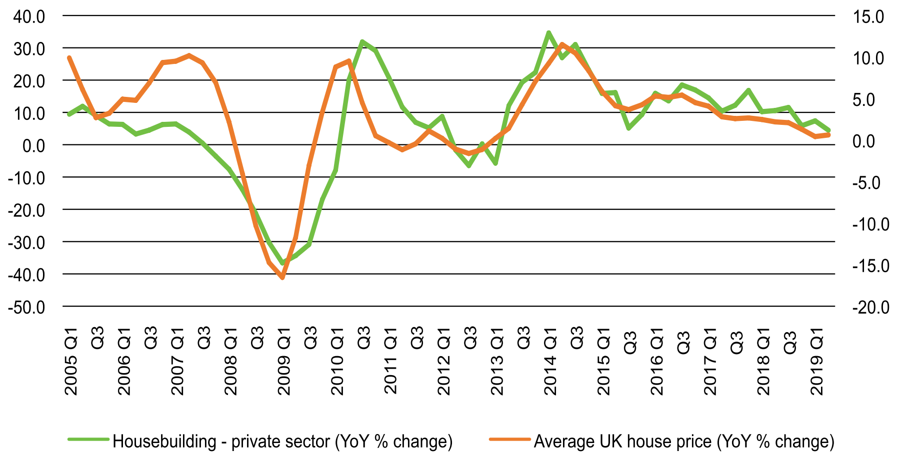
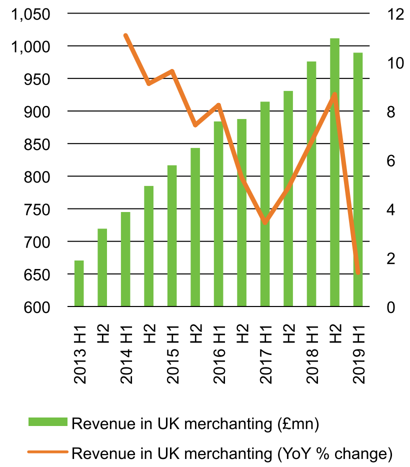


Chart 4: Private Sector Investment in New Housing Construction vs UK House Prices, 2005-2019 (YoY % change)



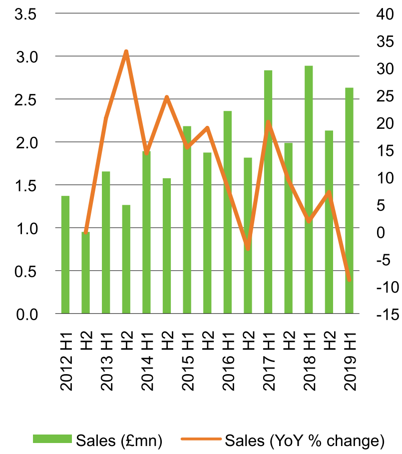
Grafton Group saw revenue growth in its UK merchanting business decelerate sharply through H1 2019 (see *chart 5)* with David Arnold, Grafton's CFO, admitting to "*hesitancy and softness*" among their UK customer base, during the company's conference call with investors on 3rd September. During a conference call with analysts in late July, Travis Perkins' CEO admitted the "*market is softening,*" acknowledged "*a bit of destocking*" and sounded "*a note of caution for the H2 outlook.*"

Chart 5: UK Merchanting Sales at Grafton Group (£)



Stagnant house prices meant the UK's leading housebuilders were experiencing similarly dispiriting trends. Taylor Wimpey saw its sales growth slow to just 0.8% YoY in H1 2019 while Persimmon saw revenues fall 4.5% YoY and Barratt suffered an 8.9% YoY decline in sales (see *chart 6*). Crest Nicholson also admitted that they had "*paused growth and de-risked forward sales programmes.*"

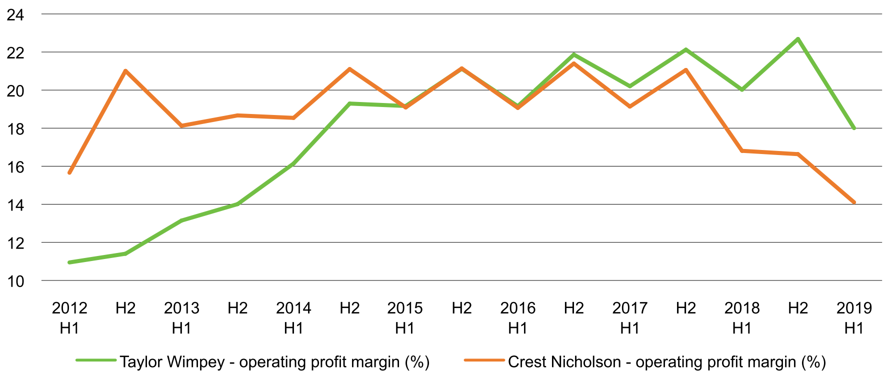
Chart 6: Sales at Barratt Developments, 2012-2019



Sluggish demand at the builders' merchants and house builders, by heightening competition, also undermined their ability to pass through any cost inflation. Grafton highlighted the "*competitive conditions in the builders' merchanting business*" and admitted that "*some competitors were more interested in volume than necessarily in price.*" Taylor Wimpey also explained that "*build cost inflation of 4% reduced operating margin by 2.3%.*" Accordingly, Crest Nicholson and Taylor Wimpey both saw profit margins fall in H1 2019 (see *chart 7*).

With UK house prices tracking sideways in early-autumn 2019, housing-related repair and maintenance expenditure stabilising and housebuilding still rising, albeit more slowly, realism has replaced the excessive enthusiasm evident across the construction product supply chain through late-2018. Moreover, the bank of England is offering increasingly strong signals that interest rate cuts lie ahead. This would provide important sustenance to an industry into which capital continues to flow and where underlying confidence remains high.

Chart 7: Operating Profit Margins at Taylor Wimpey and Crest Nicholson, 2012-2019 (%)



David McCulloch
Corporate Strategy Advisor

This analysis of the housing market was brought to you by David McCulloch, Corporate Strategy Advisor for BSW Timber.

It should be read in conjuction with The UK Forest Market Report 2019 a copy of which can be downloaded from either the Tilhill Forestry website: www.tilhill.com or from John Clegg & Co: www.johnclegg.co.uk