

Preview of McCarthy & Stone: Largest UK Retirement Homebuilder

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The following is an excerpt from a letter of Seven Pillars Income Opportunity Fund.

We believe there are three sources of permanent capital loss: (1) business risk: the risk that intrinsic value declines due to a change in the competitive or regulatory environment, or declining standards of stewardship for example; (2) balance sheet risk: the risk that the capital structure is imprudent given the characteristics of the business and industry, and that equity value may be transferred to debt owners, and (3) valuation risk: the risk that we pay a price that is inconsistent with a wide margin of safety. Buying companies at steep discounts to private business value lowers the odds of permanent capital loss, even if the future unfolds in a less favourable way than expected.

We believe that our ownership of the shares of McCarthy and Stone (MCS) is consistent with our focus on downside protection. MCS is the largest retirement housebuilder in the UK. MCS buys land, secures planning consent, builds, sells and manages housing developments specifically designed for retirees.

Business risk

In our view the risk of intrinsic value erosion is modest due to a number of factors:

Competitive position. In MCS's 40 years of operation, it has enjoyed a dominant position within a largely uncontested niche. Major homebuilders have tried and failed to enter this market. MCS is the dominant provider of owner-occupied retirement housing in the UK; it built its first development in 1977 and has a 70% market share today. Private competitors include Churchill (MCS's nearest competitor but with only a fifth of the volumes), Pegasuslife and Beechcroft but these are much smaller, regional operators. A significant portion of retirement housing is publicly owned and takes the form of 'sheltered housing', owned by local authorities, the majority of which was built in the 1960s/70s. Apartment design is fairly standardised; MCS's scale and ability to utilise repeatable processes is a cost advantage. MCS also enjoys planning advantages due to the social value of its products. It is subject to less onerous Section 106 and CIL charges than mainstream developers and other land users, which relate to obligations to contribute to local infrastructure.

Low development risk. MCS acquires sites through conditional purchase contracts, mainly conditional on the granting of planning consent. In many cases contracts will include commercial viability clauses which give MCS the flexibility to cancel purchases for projects which become uneconomic. In market downturns, MCS can exit conditional contracts and sell land to non-residential interests such as supermarkets and other commercial interests. Customer credit risk is modest; retirement homes are typically sold to equity rich cash buyers not usually reliant on cheap debt.

Long-term and aligned management incentives. The prior management team was focused on operating margins but not asset turns/capital efficiency. They were therefore not incentivised to maintain through-cycle capital discipline. An incentive plan was put in place by the current management team,

a feature of which is a three year vesting LTIP in part driven by return on capital employed.

Balance sheet risk

MCS finances its operations from operating cashflow; shareholder equity represents 90% of long term capital. Financial gearing has dramatically reduced since the financial crisis from 10x net debt/operating profit to 0.3x today. Working capital is a much larger use of cash than fixed assets; this low level of operating leverage complements the prudent capital structure of the business.

Valuation risk

MCS's current market cap is £800mn and its enterprise value is £830mn. With reported net assets of £700mn, invested capital in the business is currently £730mn; the quoted value of the enterprise is just 14% higher than this. This for a business currently generating 20% ROCE (return on capital employed) and targeted ROCE of > 25% on new investments. There seems to be a substantial opportunity to reinvest operating cash flows into the development of more homes for a long time. MCS estimates that almost one million households are in the optimal bracket of being 75+, living alone/with a spouse, and having high housing wealth. Yet only 140k units have been built to date in the UK. This c800k shortfall is large in the context of the market leader's targeted production of 3k pa.

Yet the current valuation implies that MCS can barely out earn its cost of capital, let alone reinvest significant levels of cash into value accretive projects. Our variant perception is that this is a better managed and more appropriately capitalised business since the capital ill-discipline of the financial crisis, and that a significant runway for supernormal capital redeployment should facilitate satisfactory compounding of earnings, assets and dividends for a very long time.