

Vistry Group PLC (LON: VTY) Call with Richard Cook at Clarion

Is there a moat?

Daikoku Capital, Arcata Capital

We will structure this document by posing a question, providing as close a representation as possible of what Richard answered. For the sake of simplicity, we have structured the questions in chronological order. The answers have been shortened and are not verbatim representations.

1) What is your background, and could you walk us through your role and expertise?

- a. Director of Clarion, which is, to put things in perspective, the largest affordable housing provider in the UK.
 - i. Affordable housing is for low-income households in the UK.
 - ii. People who cannot access housing through the normal market conditions (market rents or market sales)
 - iii. State-subsidized housing, so some state-forced intervention.
- b. Engineer by background
 - i. Started off in engineering companies doing energy and microchips and then moved into residential 30 years ago.
 - ii. Graduate in construction management.
- c. Worked at Lendlease before working at Clarion, which is a large Australian company.
 - i. Built a lot of the high-rises around Central Park
 - ii. Main contractor for many of the expensive billionaire's row buildings
 - iii. At Lendlease for 10 years
 - iv. Oversaw their residential business across the globe.
- d. Now runs the development business in Clarion, which is the new homes-built program.
 - i. Team of 300 professionals and currently delivering between 2k to 2.5k homes per year
 - ii. Big mixed-use projects

2) Could you give background on the role of housing associations and how they have changed over time? Under Margaret Thatcher, many local councils' power moved to housing associations. How do you think that has impacted the availability of affordable housing in the UK?

- a. Late 1800s and early 1900s, employers were providing accommodation for workers. These were called workhouses.
- b. This was a common theme across the globe where employers created accommodation for workers.
- c. Rich philanthropists who were making money in businesses and then reinvesting into creating places for people to live
 - i. Quaker families were creating communities for their workers.
 - ii. The Peabody family were also philanthropists, and they donated their wealth to create homes for the poor.
 - iii. William Sutton created door-to-door parcel services. He left around \$200mm GBP in today's money to build homes for the poor.
- d. Trusts over an amount of time and amalgamation and mergers ultimately became housing associations.
- e. Huge amounts of investment were made after WW2, when local authorities invested in social housing, primarily homes for rent.
- f. Through the 40s, 50s, and 60s, the UK housing stock was rebuilt, and that was mainly driven by government intervention and government funding.
 - i. This was happening all over Europe, given the destruction.
 - ii. Huge amounts of money went into the housing stock.
- g. What then happened in the early 80s was that Margaret Thatcher came to power.
 - i. Thatcher was very focused on home ownership, so a scheme called "right to buy" was introduced.
 - ii. "Right to buy" allowed people in local authority housing to buy their homes at discounts.
 - iii. So a lot of the social housing stock was transferred then at discounted prices to private ownership
- h. It was government legislation that led to trusts becoming housing associations.
 - i. Trusts became associations, and it became a regulated environment.
 - ii. All affordable housing has a regulator.
- i. Over the last 10 years there has been a lot of growth of the bigger associations as there have been mergers
- j. The biggest issue for the last thirty years has been that the government has invested very little in social housing/affordable housing.
 - i. A first-world problem: very little investment has gone into affordable housing and has been left to housing associations in the UK and the private sector, which do very little.

- k. The biggest challenge in the UK is that the affordable housing stock has been reducing year over year since around 1985.

3) Can you help us better understand the value chain and where housing associations fit into it?

- a. The majority of the housing is built by the private sector, which is housing for sale.
- b. Currently, around 220,000 homes are built per year in the UK, and the private sector delivers about 180,000 of them.
 - i. 50% of the capacity comes from the top 20 homebuilders.
- c. Sat underneath the private sector are housing associations
- d. Clarion uses its cash roll to generate debt, which is then used to build housing. Housing associations are the second tranche of housing delivery.
- e. The third tranche is local authority investment, which is quite a small area.
- f. The main source of investment in the UK housing market is the private sector, which is building speculative homes for sale.
 - i. Finally, the private sector also generates multifamily and single-family rental homes.
- g. The housing associations are in the middle and are focused on delivering affordable housing.
- h. The private sector delivers affordable housing through what's called Section 106s or planning gains.
 - i. That is where they are obligated under a Planning Commission, and you would call it zoning. The private sector is then obligated to deliver a percentage of affordable housing.
- i. There are three methods of housing delivery. Some stuff is on the edges, like self-build, but their market contribution is minimal.
- j. Local authority deliveries are pretty small unless there is a change of government. It will still remain pretty small.

4) You said that housing associations do deliver homes, so are they not working in partnership with any more traditional home builders to do that?

- a. Clarion is delivering around 2,000 homes this year. For around 1,000 of them, Clarion will deliver themselves, and then for around 700 of them, Clarion is doing equity joint ventures with several big national house builders and developers.
- b. For the remainder, Clarion is acquiring the housebuilder's affordable housing, which is the planning gain element.

5) Why can't Clarion do all of it themselves?

- a. Financial capacity and land
 - i. Land and planning are the biggest things that hold development back in the UK.
 - ii. The UK is a small country that is very constrained from a land perspective, and it has a high population.
 - iii. You can look at Manhattan as an example where the land is pretty controlled by people who want to bring it forward and maximize the value of the land, so it leads to a situation where you are incentivized to build higher and more densely.
- b. London is very similar to the Manhattan model; the values might be slightly different.
- c. The UK planning system is more archaic than in the US.
- d. Every local authority has its own plan and politics of how it deals with land planning.
- e. Clarion lacks financial capacity. It can't acquire enough land, so it works with other people to bring land forward.
 - i. Everyone is always squabbling for land.
 - ii. Land, especially in areas of population.
- f. In the UK, land is very constrained by not in my backyard and NIMBYism.
- g. Every local authority is politically driven, and ultimately, the councilors who are in those local authorities are the ones who actually make the decisions. Their only worry is about getting elected every four years.
- h. The bottom line is that planning is a politically driven decision-making process.

- 6) You mentioned that 700 homes were delivered through the equity joint venture, and I assume that is with traditional volume home builders. Is there any differentiation between Taylor Wimpey, Barratt, Vistry, or Countryside to you? Are they all effectively the same, or do you specifically want to partner with one of them?
- Vistry/Countryside is a good example of what to look at. Vistry has a 'partnership model' that, at large-scale sites, involves a minimum of 1/3 affordable housing, 1/3 single-family homes, and 1/3 private sale.
 - The Vistry model is built around ROCE (return on capital employed). Low cash and high output is their model.
 - The Taylor Wimpey and Barratt model is a very traditional housebuilding model. They get planning permission on a piece of land and then build for sale. They build at the sales rate of about 0.75 houses a week. If the market is better, they will build faster; if the market is slower, they will build slower.
 - The goal of volume housebuilders is to maintain the land and maximize revenue and margin, unlike the ROCE model. Their model is based on sales demand-driven output. If they turn to building more affordable housing, the demand will be enormous, given the phenomenal demand for affordable housing in the UK.
 - You could build 90,000 social rented homes yearly for the next 10 years and demand would still not be met.
 - The demand for affordable housing is deep, but the question is who can fund that.
 - There are two dynamics: the proper house builder model, which is built for sale, and a partnership dynamic, of which Vistry is an early adopter.
 - Pretty much guarantee that the housebuilders return to the build for sale model at the earliest opportunity.
 - They do that because they do not want to burn through the land too quickly, and land is the biggest constraint.
- 7) In Vistry's case, the land can be donated, or the housing association/local council can acquire it. Why do Taylor Wimpey and Barratt not want to switch to a partnership model, given that it enjoys a much higher ROCE? Are they not able to, or do they not want to, and if not, why?
- The cynical side says that Greg Fitzgerald is on a three-year earnout bonus, and he is trying to maximize shareholder returns.
 - Clarion and Richard know the business well because they do a lot of work with them.
 - The biggest challenge Vistry will have is replenishing their land bank for their volumes.
 - Countryside also used to have this model to a degree, but not to the aggressiveness of Vistry
 - Fundamentally, any homebuilder needs a land bank. Vistry currently has a land bank that they are burning through quickly. They are not looking to replenish it. Ultimately, one has to be reminded that if Vistry wants to get to 18,000 to 20,000 homes per year, maybe they do that for one or two years, but they will need to continually have a market to sell to and, more importantly, keep filling up the land bank at commercial rates.
 - Vistry's current short-term advantage is that Vistry bought Countryside, giving them a double land bank, but they could exhaust that quickly.
 - The rest of the housebuilders work on a three-year land supply model, as they always have. So, they plan for a three-year program.
 - It is either capital light, which is the Vistry model, or margin-enhancing, which is the National House Builder's model.
 - The current model in the UK has been like this for the last 30 years.
 - At Lendlease, Richard used to buy huge areas of land, get it sorted, and then sell plots. All they did was sell off the plots of land. That is what Lendlease did on a volume basis. Interestingly, the actual value or profit is in building and selling the homes.
 - You are making a margin on the money you spend. It is just different models for different places.
- 8) Would you say that nothing prevents Taylor Wimpey or Barratt from doing the same 'partnership' model as Vistry if they wanted to?
- Taylor Wimpey and Barratt could follow the exact same model as Vistry. At the end of the day, it is all about strategy and shareholders. Ultimately, most PLCs are owned by shareholders.
 - Clarion works with a company called Hill, which is a privately owned company. They are very good developers, and Clarion has a couple of joint ventures with them. Hill is a privately owned builder doing about 2,000 homes a year, but their balance sheet is only of a certain scale and size, so they want to maximize every

home they build and every piece of land or land plot they have. So Hill will never run off and suddenly accelerate affordable housing supply because they want to maximize their private sales business.

c. There is only so much land.

9) Are the housing associations or organizations like Homes England not land-rich? Is it not that they have a lot of land that they want developed to bring affordable housing to the market and that they want to work with someone like Vistry or Countryside? Is that not the dynamic?

- a. Homes England differs from the housing associations. Clarion has around 20,000 plots in its portfolio, which equates to about a five-year land supply.
- b. Clarion uses some of that land with joint venture partners, and for some of it, Clarion develops itself.
- c. Homes England is ultimately a government entity that controls government land. Its intent is to drive accelerated housing market volumes. Homes England is a strategic partner to Clarion. Homes England applies grant funding to affordable housing.
- d. One can't afford to build affordable housing on one's own. It does not work. The model does not work. It is loss-making. So you get a grant, which is the difference between what it costs to build affordable housing and what it is worth from a 30-year cash flow.
- e. Homes England looks after the grant program and gives Clarion grants to build affordable housing. It is there to facilitate 'unviable sites' and government investment in the housing supply.
- f. Homes England works with housing associations because most of the housing associations are charitable, not for profits.

10) Could you discuss the economics of forming a 'partnership' or equity joint venture with someone like Vistry or Countryside and what that looks like?

- a. Clarion has a couple of public joint ventures. Clarion has 40 JVs with Countryside.
- b. For Clarion, the JV is very simple. It is pound-for-pound equity. Both Clarion and Countryside put in a pound each. This shares the risk and allows Clarion to do bigger projects with a reduced equity contribution.
- c. Countryside and Clarion acquire a site 50/50. They deliver the project with 35% affordable housing, and the rest is for private sale.
- d. The outturn of the affordable housing automatically goes to Clarion, which means Clarion gets its affordable housing automatically. The housing is forward-funded, which reduces the JV's equity.
- e. It is also a pound-for-pound profit share and is just about sharing risk.

11) Are there any other JV formats or structures out there?

- a. There probably are, but Clarion would not do a JV unless it were pound-for-pound.
- b. The JV model is very simple and structured, as if Clarion was doing it with a private equity house. Vistry gets the same terms.

12) Is there any pre-selling involved in these deals?

- a. It is the pre-selling of affordable housing.
- b. The affordable housing is pre-sold to Clarion. The JV sells it into Clarion, and that is on a forward-funded basis.
- c. But again, it all depends on the size of the site or the project.

13) You gave a cynical take on Greg Fitzgerald and his payout, but otherwise, what do you think his standing is in the industry, and how would you describe him?

- a. Greg is a good guy. He has done very well for himself.
- b. His remuneration was not seen as very ethical, with shareholders having voted against it, but the American private equity guys are backing them.
- c. The longevity of relationships will stand the test of time. It will be interesting to see in three years.
- d. Richard does get the model to a degree but thinks it is very aggressive in the short term.

- e. However, in the medium term, Vistry will face other challenges. Richard is not sure how Vistry will keep replenishing its land bank at commercially viable terms. Vistry at present is really doing a very good job of sweating their assets.
- f. But if Vistry wants to drive the best value out of the land then that might be a different thing.
- g. Greg has retired twice since Richard has known him. Richard is certain that Greg's remuneration will allow him to retire for the third time, a very wealthy man.

14) We have viewed the 'partnership model' in that Vistry or Countryside's goal is not to have the land bank; instead, they are working with housing associations and using their land. Is this assessment unfair?

- a. Most of the work that Clarion is doing is with Vistry's landbank. Vistry comes to Clarion with land, and Clarion has bought into it.
- b. Clarion's 4 significant JVs with Vistry are on existing Vistry land. Most of the JVs are present on land that Vistry controls.
- c. In London, the Countryside business did a lot of regeneration work, which is different. That is using the housing association's existing land and stock to regenerate in London.
- d. But there is not a lot of that going on now. There are other places in the market, and all that is very London-centric. This model does not work well outside of London because you can't get values. Regeneration works in London because the values are high.
- e. By the time you knock down the existing stock, rebuild the new stock, and double the density, you have a fairly viable business model. However, once you move out of London, the values drop considerably, and the model fails to work. Trying to do regeneration out of London is very challenging.
- f. If you look at Vistry's pipeline, few projects will use other people's land.

15) Could you give us any examples of regeneration projects and how they would work compared to more traditional housebuilding?

- a. Traditional sites are easy. You buy a piece of dirt and build on it. It can be either brownfield or greenfield. With regeneration, you take existing housing stock.
- b. Merton is an example. The JV will knock down 1,200 homes in Merton and build 3,000 over the next 10 years.
- c. It sounds really easy, but it isn't because you have to rehouse the 1,200 people who are already living there. This means that you will have to build some new homes to move the people out of the old and then build some more new ones to move them out of the old. Finally, you get them out of the old so you can build many new ones.
 - i. This is complex and quite political.
 - ii. In London, the mayor requires the ballot now.
- d. When somebody comes up with the idea of doing regeneration to move the first person in, it can be a 7 to 10-year process.
- e. The end game is very good, but getting there is generally very expensive and entails a lot of fees.
- f. This does ultimately enable the densification of London. A good example of this is Elephant Castle.
- g. You also have to buy back people's existing homes before you can start to redevelop the site.
- h. Clarion tends to regeneration itself, as they are putting in 100% of the effort but only getting half of the profit. Vistry does not bring much to the table when it comes to regeneration from Clarion's standpoint.