"Real estate markets are amongst the most unstable and cyclical asset markets, exhibiting large amplitude cycles of 10-20 years. Real estate constitutes a large fraction of the total wealth in any economy, generates a significant portion of banking activity and debt, and strongly effects the job market."

*Business Dynamics: Systems Thinking and Modeling for a Complex World, Sterman, 2000*

Significant household investment decisions depend on confidence, or ‘animal spirits’, which are clearly emerging in the USA. As per history, this confidence will manifest in households making high value purchases – particularly new residential housing.

**Analyst forecasts are too conservative**

Market analysts are expecting construction of new US housing will take four years to grow from their current level of 1.2 million per annum to the long-term average of 1.5 million per annum.

**This forecast seems too conservative.** We provide evidence of the pent-up demand¹ for housing and then describe why the conditions exist for this potential demand to translate into actual demand that will exceed 1.5 million new houses.

The chart on the next page provides historical evidence that many times new US housing construction has far exceeded the 1.5 million per annum currently forecast by the market.

¹ Pent up demand is used by economists to describe the general public’s return to consumerism following a period of decreased spending
THE RECOVERY IN THE US HOUSING MARKET

The chart below shows the cyclicality of US housing construction levels since 1960. The red line shows the linear growth of the US population. The blue line illustrates the level of new housing construction over the previous 12 months.

We can see the ‘overbuild’ that occurred prior to the global financial crisis in the blue bubble. The green bubble illustrates that subsequent underbuild from 2009. The chart also shows us that throughout history (four times in the last sixty years) housing starts have peaked well above the ‘average’ of 1.5 million per annum, in some cases above two million.

US Population vs US Annual Housing Starts

Source: John Garrett, Moelis and Company, 2016

The ‘overbuild’ of housing in the USA prior to the crisis

The subsequent seven year ‘underbuild’ in the USA
PENT UP DEMAND FOR HOUSING

“Production levels in the 1 to 1.2 million starts per year range are still too low for the needs of American household growth that is now normalising”

US Homebuilder Lennar Corp, December 2016 earnings call

Annual US housing construction has been below average for the past seven years. This suggests there have been too few houses built, creating pent up demand. We provide two key pieces of evidence to highlight this potential demand:

The natural demand for housing

We estimate that the natural demand for housing is approximately two million units per annum. We calculate this by assuming long term average population growth of 0.9%, an average household size of 2.5\(^1\) and an obsolescence rate of 0.6\(^2\).

“Sustainable demand for US housing is conservatively estimated an average of 1.95 million new units per year.”

Joint Centre for Housing Studies, Harvard University, 2007

Compared to our assessed two million per annum new housing requirement, the average build over the past seven years has been just 850,000 per annum. This below average annual build is fair considering the housing overbuild prior to the global financial crisis, but the chart below from the US Census now shows the market has now moved into a shortage of 700,000 houses.

The reason for the weak level of demand is weak household formation, which we discuss on the following page.

\(^1\) US Census, 2016

\(^2\) Obsolescence rates (or homes that are demolished and rebuilt) are difficult to estimate and experience cyclicality. We have been conservative in our estimate of 0.6% of the housing stock being rebuilt each year.
Weak household formation the culprit

The reason that demand for new housing has been so far below long term averages is because US household formation has fallen since the global financial crisis.

The reduction in new households is because a weaker economy has caused young adults to seek alternative residential choices such as living with parents, other relatives, or friends.

“The muted recovery in the housing market can be traced in part to the slow pace of household formation, especially among young adults”

Federal Reserve of San Francisco, Economic Research Department, 2017

We argue that these alternative living arrangements are temporary. The natural human desire for independence and to start a family – combined with supportive economic conditions – should see household formation recover1.

If we assume household formation increases back to more normal levels, we would expect an increase in demand for one million new houses. This is in addition to the natural annual demand for housing of 1.5 to 2.0 million houses per annum.

Now that we have shown that new housing construction has lagged probable demand we will illustrate why current economic conditions should permit potential demand to translate into real demand.

The five conditions supporting a strong recovery in US housing starts?

Condition One ➔ Affordability

Home affordability is at strong levels. The higher the blue line in the chart below the better US housing affordability is.

1 The mean average of a mother at first birth has been rising, from 23 years old in 1980 to 26 years old today: National Vital Statistics System, 2016
Condition Two → Mortgage rates are rising – ‘creating a fear of missing out’

There has been a mild slowdown in new housing mortgage growth because mortgage rates have been increasing recently. This seems logical, but we do not expect it to last. Perversely, rising mortgage rates create a sense of urgency to borrow (animal spirits). We expect demand for household credit to rise as households act to lock in historically low interest rates.

“All want to get their loan closed before rates move up”
John Shrewsberry, Bank of America Chief Financial Officer, January 2017

Condition Three → US house prices are rising

US house prices are rising. The chart on the following page shows house prices have completely recovered from the 20% decline caused by the global financial crisis.

Just as rising interest rates can perversely spur economic activity, history shows the psychological impact of rising house prices can create further demand for housing because it creates a sense of urgency, or a ‘fear of missing out’.

---

1 Federal Housings Finance Agency
Condition Three → US house prices are rising

![FHFA US House Price Index](chart.png)

The Federal Housing Finance Agency US House Price Index tracks the average price changes of single-family house prices.

Condition Four → Availability of financing is improving

It is well appreciated the chief cause of the global financial crisis was US banks lent to customers that could not afford to service the loans. This caused default rates to rise from the long-term average of 2% to 11%\(^1\) and the residential housing market crashed.

Since this time, the US banking system tightened lending standards – driven by risk-averse bank leadership combined with regulatory authorities threatening legal action against them if they made loans to customers with weak credit scores.

“It has been historically very hard and risky for a bank to make a loan to first home buyers, even though they could be very good people with brand new jobs”

JPMorgan Chase CEO Jamie Dimon in response to a question about the ability to increase lending to first home buyers: December Quarter 2016 earnings call

We are now witnessing moves by Federal housing policymakers and mortgage lending groups to expand access to home loans for greater numbers of creditworthy buyers. The industry is calling this concept “opening up the credit box”.

Banks are now gradually loosening their credit standards as they ease up from the strict standards set in place after the financial crisis.

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\(^1\) Federal Reserve Bank of St Louis 1996
Condition Four ➔ Availability of financing is improving

“Compared with the results of the 2015 survey, examiners noted double-digit increases in the percentage of banks that eased lending practices in residential real estate loans.”


“Every quarter when we look at our housing mortgage portfolio, and we’ll say it can’t get any better, and the next quarter it gets even better”

Comment from the CEO of major US home lender Wells Fargo: Goldman Sachs US Financial Services Conference, December 2016: in response to whether consumers are likely to increase their borrowing

 Despite the recent fall in credit growth caused by interest rates rising, we expect it to resume as confidence continues to increase
Condition Five ➔ Ability and willingness to borrow

The emergence of strong wages growth and falling unemployment levels has historically been a precursor to household’s willingness to borrow and for a bank’s willingness to lend.

The final supporting variable is the participation rate of the US workforce, which is still relatively weak, having fallen from 66% of the population to 63% since 2008. This is the key variable we will be monitoring. We will need to see an improvement in the participation rate to support our thesis that the US housing market will recover strongly.

Nonetheless, strong wages growth is a lead indicator of a rising participation rate, and highly correlated with household formation.

US Housing ➔ strong potential demand and the right economic conditions

We have highlighted that there has been significant underbuild in the US housing market for seven years, creating pent up demand. We have then shown that the economic conditions exist for this potential demand to translate into actual demand.

Our work has led us to forecast new US housing construction to rise more rapidly than current market expectations. We expect 10% per annum growth over the next four years, rather than the 3-5% per annum growth forecast by market analysts.

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1. The participation rate is a measure of the active portion of an economy’s labour force. It refers to the number of people who are either employed or are actively looking for work.
3. Ibid.
Boral Limited (BLD)

Our exposure to the recovery in the US housing market is via Boral (BLD).

BLD is a company that manufactures and distributes building materials in Australia and in the USA. Products include concrete, fly ash, plasterboard, cement, bricks, masonry, roofing and timber.

The negative response to a recent major acquisition has created the opportunity

During November 2016, BLD acquired a US building and construction materials company called Headwaters for AUD $3.5 billion. The acquisition was significant for BLD, the value of the bid for Headwater represented 80% of BLD’s market capitalisation of AUD 4.3 billion.

The market generally viewed the BLD transaction negatively. The perception was BLD paid too much for Headwater, particularly considering the high degree of risk in joining the two companies together.

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1 This acquisition was funded by $2.1 billion capital raising at $4.80 per share (the market price of BLD was $6.15 prior to the deal, so a 22% discount) and $1.4 billion in debt and cash.
The negative sentiment provides the opportunity

Whilst we concede the negativity toward BLD has some basis, the share price of BLD has fallen to a point to more than factor in the risks of the Headwater acquisition, and more importantly allowing us to gain exposure to a US housing recovery we assess will be faster than expected.

There are some potential positives from the deal...

We do see some positives from the Headwater transaction. In addition to increasing BLD’s exposure to the US housing market, the acquisition will see BLD move to dominant market shares in some key building material product lines. BLD will have a 50% share of the US concrete and clay market, 60% of stone and 55% of fly ash.

On the back of greater dominance in key product lines and greater scale, BLD has put forward some reasonably aggressive synergy targets, expected to be $100 million over the next four years, coming from:

- Procurement (ability to source raw materials at lower prices due to buying power)
- Operational cost savings (fixed cost overheads, economies of scale)
- Cross selling and distribution (economies of scope)

If these synergies are achieved, the price BLD has paid for Headwater is much more reasonable, but we accept the market will not believe them until there is further evidence.

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1 Headwaters – more than a drop in the ocean, Morgan Stanley, James Rutledge, December 2016
2 Fly ash is a by-product of coal combustion in power stations. When added to concrete it improves its overall performance and quality. Fly ash is a substitute for cement.
Boral Valuation

How are our forecasts for BLD earnings different to market forecasts?

In our valuation of BLD we assume the following:

- A 10% per annum recovery in new US housing construction (the market is at 5%)
- A decline in Australian new housing construction from 250,000 to 160,000
- A 6% per annum increase in renovations in the USA
- A recovery in Australian non-residential construction (fixed asset investment)
- $75 million in synergy benefits from the Headwater acquisition

Once we have included these assumptions into our model, we assess we are paying approximately **11 times 2019 earnings** for BLD. Furthermore, we expect that market will be pricing in further growth from 2019 as we will only be part way through the US new housing construction recovery.

Whilst a judgement call, we expect the market will be willing to pay **16 times for BLD's 2019 earnings**, implying **40% upside** from the current share price of $5.60.

We believe the mispricing of BLD shares is caused by negative sentiment towards the recent Headwater acquisition as well as scepticism around the trajectory in the US housing market recovery.

For our price target to be met the market will want to see evidence of the US housing based earnings recovery, and can see that a decline in Australian housing starts will be offset by Australian non-residential fixed asset investment.

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**FUND PROFILE**

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<thead>
<tr>
<th>Fund</th>
<th>Newgate Absolute Return Fund</th>
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<td>Investment Objective</td>
<td>Generate returns of between 12-15% per annum over rolling three year periods with target volatility of less than 15%</td>
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<td>Fund Inception</td>
<td>7 August 2016</td>
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<td>Trustee:</td>
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<td>Fund Manager:</td>
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<td>Custodian:</td>
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