The UK economy is well underway to recovery, no doubt helped by stabilising and improving house prices.

But this national picture of rising house prices in no way reflects the reality on the ground, or the fact that the superheated London property market is largely driving this statistic.

Some of the recent momentum can be attributed to measures announced by the Chancellor in the March Budget. A new 'Help to Buy' scheme was launched, aimed at further stimulating the housing market by making it easier for home-buyers to borrow money.

However, this scheme has been criticised by both the International Monetary Fund (IMF) and the government's very own Office for Budget Responsibility (OBR) for potentially inflating house prices.

Many economic commentators believe we are undergoing a phoney recovery.

Even Nationwide concedes that “real earnings growth remains sluggish”.

What we have today is strong house prices without earnings growth.

This is a clear indication that the UK property market is being propped up by government policies that ultimately just leaves people saddled with more debt. That’s the thing about distorting the market, history teaches us that it ends in tears.

Evidence supporting this comes from many quarters, but in particular the retail sector, and the major grocers. Tesco, Morrisons and other retailers are losing money and market share hand over fist to discount chains Aldi and Lidl.

Arguably if we were seeing evidence of the current recovery in every corner of the UK, the major grocery retailers would not have seen such a downturn in sales as households opt for cheaper products and lower bills.

Households are about to get squeezed even more. Rate rises are coming... and soon.
Interest rates have been frozen at 300 year lows for around 5 years now. But there is a growing expectation that the Bank of England will start to increase rates later this year.

The Governor, Mark Carney, recently warned that rates could rise sooner than markets were expecting. And even the Bank of England’s biggest dove, David Miles, says he’s likely to vote for a rate rise in the months ahead as the time comes to ‘normalise policy’.

People quickly forget what normal means. By the mid-1990s up until the recent financial crisis, the UK base rate had settled at around 5% and stayed in a nice little range for a decade and a half. That’s 10 times the level of today’s base rate!

Another way to assess what a normal rate means is to consider the inflation rate. When you look back historically, the base rate has typically hovered around 3-4% above the inflation rate. So at today’s inflation rate of 1.5%, a normalised base rate would be around 5-6%.

This era of ‘cheap money’ and ‘government giveaways’ has been great for the UK housebuilders. Schemes such as Help to Buy have literally provided rocket fuel for shares in the big listed housebuilders and property companies.

As you can imagine, there’s been something of a land rush as housebuilders seek to ramp up volumes while the going is this good. But anyone that knows a thing or two about the property market will tell you it’s a highly cyclical business. The time to worry is when people stop worrying.

I spoke to a top executive recently at a large privately-held housebuilder. He was shaking his head at what’s going on in the market right now. “The big boys never learn” he told me. “We’re pulling out of projects because the numbers don’t make sense. But those guys just think short-term. They’re now switching to volume targets [rather than profitability targets]. It’s going to end badly again”.

Certainly when you look at the results being reported in the sector, the listed housebuilders look in great shape. But don’t be fooled. We’ve been here before, not so long ago, and when things unravel, they unravel quickly.

In this report we look at three stocks we believe are vulnerable to a correction.
Barratt Developments (BDEV)

In a Q3 trading update on May 8th, Barratts said that increased buyer confidence and “the availability of attractive mortgage finance continue to support strong consumer demand for our homes.”

Barratt also noted that the Help to Buy equity scheme “remains a very attractive opportunity for our customers and, in particular, is supporting first time buyers.”

For the reporting period, Barratt said that 2,150 of its new home reservations used the scheme, with a total of 14,250 units expected to complete in 2014.

Barratts have secured “excellent land opportunities across all regions”. This commitment to buy-and-build ties up loads of capital, which is fine and good so long as the housing market continues to grow at the current rate.

The percentage of new home reservations using ‘Help to Buy’ vs. total completions expected for the year currently stands at 15% and will rise substantially. Any housing market correction will severely impact on these numbers, and prompt a significant downward readjustment in forward sales estimates.

Bellway (BWY)

On June 5th, housebuilder Bellway published an interim trading statement, and said it has spent £400m on land and land creditors since August 1st, up from £270m for the same period in 2013.

The housebuilder also recorded an average of 177 reservations per week since February 1st (2013 - 160), up 11%, while ‘Help to Buy’ had resulted in 879 reservations for the same period. CEO Ted Ayres said the company remained “well placed to deliver further enhancement to shareholder value.”

Although Bellway made a point of highlighting the improving strength in its balance sheet, the housebuilder recorded 3717 reservations over the period, of which 879 were ‘Help to Buy’ reservations. This means that the government-sponsored scheme has resulted in a 23% hike in reservations for the period.

Once again, any housing market correction will leave a big hole in Bellway’s forward sales estimates, and at the very least send the shares back to where they started the year.
Redrow (RDW)

On April 29th, Redrow published an interim statement covering trading for the 17 weeks from 1 January to 25 April 2014. Redrow said that net reservations for the period were up 17% at 1,280, and that the average selling price of private reservations for the financial year to date had risen 16% to £289,000, mainly due to an increasing proportion of sales in London and the South East.

Legal completions in London are progressing well, and Redrow expects this division to contribute c.£120m of turnover in the current financial year. The housebuilder added that the Government's announcement of the extension of the Help to Buy scheme "provides a stable platform to increase our investment in new sites and grow our output."

Due to the timing of investment in land, Redrow’s net debt at 25 April 2014 was £153m, ( £149m Dec 2013). Net debt is expected to be c.£200m at the end of June 2014.

As with Barratt and Bellway, Redrow is confident of a strong outcome for the full year. But with the smallest market cap and turnover of the three (£604.8m for year to June 2013), at £200m Redrow’s debt levels are alarmingly high, leaving the group seriously exposed to any correction. So much so in fact that a worse case scenario could even see the company go cap in hand to shareholders.
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