

## Alpha shares analysis

18 October 2021

### Don't get dragged under

*Investing in a business that is keyed into the fortunes of the UK's housing market all but assures a wild ride. At present a surging market in housing and allied industries makes for very positive results, but both a reversion to mean and specific headwinds threaten to clip the housing and allied markets' wings in 2022. When driven by such a cyclical market, investors should look for ways in which diversification and remodelling can deliver sustainable growth: only one of the three stocks we examine here has the scope to achieve this.*

#### The need to cut the apron strings to the housing market

- **Michelmersh Brick** – a surge in home improvement spending on the back of a booming housing market (stamp duty cuts and the 'dash to the country') has helped this specialist brickmaker beat expectations. However, the shares have derated sharply since the start of September as the market worries about what comes next in the face of a normalising housing market, wider inflation and for an energy thirsty industry like this, the impact of higher gas prices. Michelmersh is doing too little to offset the likely decline in home improvement spending and its current derating is unlikely to reverse, and may well continue.
- **The Property Franchise Group** – estate agency is a volatile industry which amplifies the cyclical nature of the housing market. TPFG is one step back from this market's volatility – as a franchisor for branded estate agencies it collects a more stable fee income from its customers. A recent transformative, step- change acquisition has driven a re-rating of the stock, but investors should be wary of mistaking this for sustainable momentum. TPFG has a decent model, but it has struggled to grow organically in the past and the steps being taken to deliver growth may not be enough to overcome negative housing market trends.
- **LSL** – although it operates one of the UK's largest chains of estate agents, this is a business that no longer wishes to be tarred with that brush. After a quick and severe rationalisation of the agency arm two years back, LSL is on a mission of transformation aiming to be viewed more as a financial services business. LSL is already larger than Mortgage Advice Bureau in mortgage-related advice (whose business model it largely aims to replicate) in terms of adviser headcount, but it is less profitable and certainly does not share its 30x PE rating. Even putting this new heart of the business on half MAB's rating, it is not hard to see the share price supporting a valuation above 500p, more than 20 per cent higher than today.

## Michelmersh Brick Holdings – about to hit a brick wall?



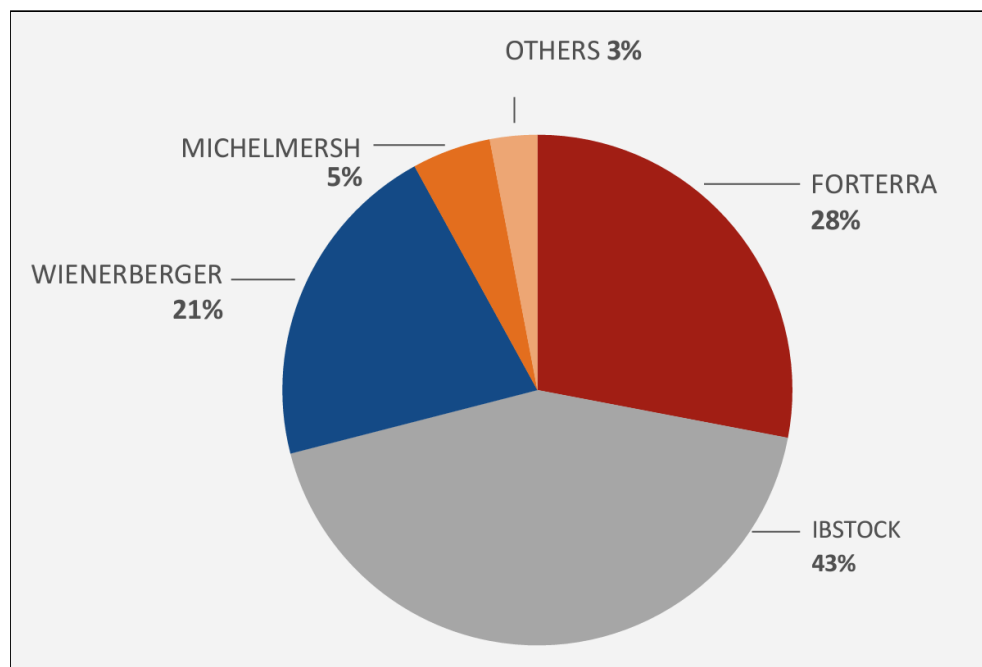
Source: FactSet

**Michelmersh Brick Holdings (Aim:MBH)** is a specialist bricks, tiles and paving products manufacturer. It is UK-based and serves the domestic housing and construction markets. While it is the second largest UK-owned manufacturer, it controls only c.5 per cent of the market producing around 37 million bricks in 2020 in a (subdued) market of around 1.4 billion pieces.

Its larger competitors are Ibstock (owned by CRH), Forterra (UK quoted – formerly Hanson) and Wienerberger (Austrian quoted – owns the Redland and Baggeridge brands). It sells generally more expensive and specialist bricks, operating from smaller bricks plants – it operates 10 per cent of the UK's factories, but makes only 5 per cent of output.

The UK brick market is both concentrated and capacity constrained with a total peak output capability of c.1.9 billion bricks per annum and 'normal' market demand (i.e. backing out the Covid effect) of over 2 billion (in 2018 and 2019). The gap between demand and domestic output is satisfied by imports into the south east from, primarily, Holland and Belgium.

**Figure 1: UK brick manufacturing market share**



Source: Michelmersh

Due to the continuous manufacturing process (brick kilns cannot readily be switched off or they will incur very significant repair costs – manufacturing is consistent across the year with seasonal demand swings met by buffering stock levels) brickmakers are typically loath to invest in additional capacity as this risks crippling losses in a sustained downturn. This, plus the limited number of players and difficulties importing profitably has long given the industry strong pricing power, which is an attraction in equity markets.

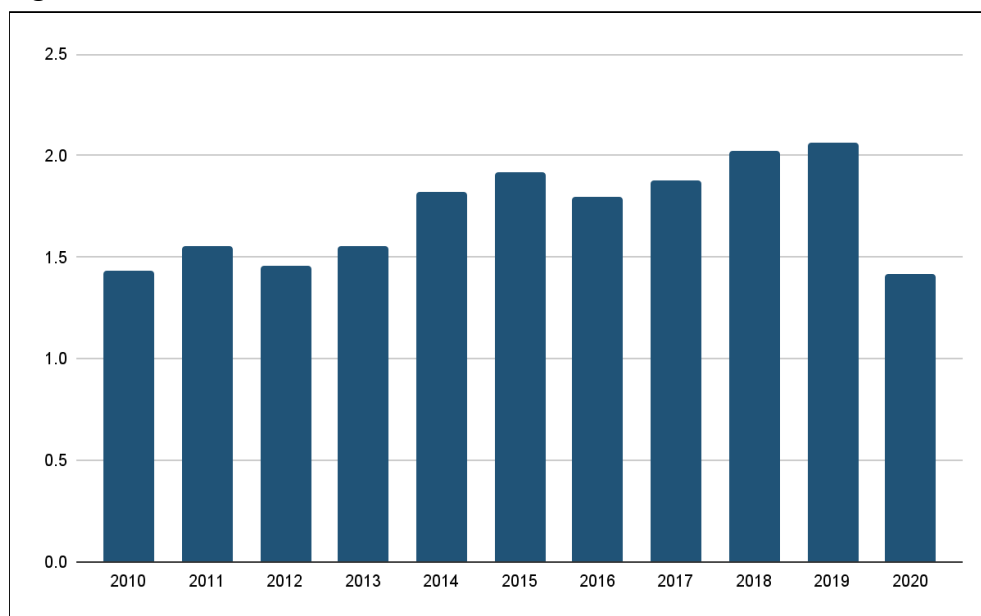
## Growth or rebound?

Along with the rest of the UK brick industry, Michelmersh in recent updates has reported very strong demand. In its most recent figures (interims reported in early September) revenues were ahead year-on-year by 33 per cent, earnings before interest and taxes (Ebit) by 126 per cent and pre-tax profit by 150 per cent.

A more useful comparison is actually how well the business is faring relative to the last good trading period: any good business that has been hit by Covid should be reporting this and Michelmersh does provide these figures. On this basis, revenues are up 10 per cent and earnings before interest, taxes, depreciation and amortisation (Ebitda) by 8.6 per cent, although the most recent period did include the Belgian business Floren (bought in March 2019) for six months versus four in the comparable period. This most likely knocks true like-for-like growth down to nearer 5 per cent.

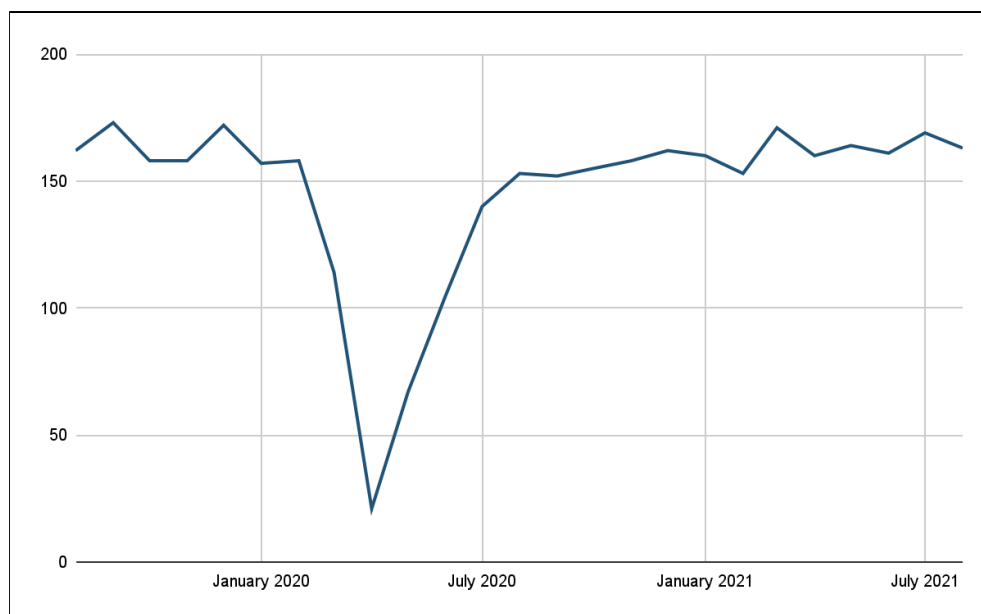
This latter figure is a far better measure of underlying performance as the movement versus 2020 is largely rebound. As the chart in Figure 2 shows, 2020 witnessed a sharp drop in production and as Figure 3 illustrates, shipments have bounced back largely to 2019 levels.

**Figure 2: UK brick production in billion pieces – domestic plants**



Source: Brick Development Association/HM Government

**Figure 3: Monthly UK brick shipments – seasonally adjusted – millions**



Source: Department for Business, Energy and Industrial Strategy

Figure 3 suggests that in the last reported period (six months to June) shipments were 969 million against 622 million in 2020, echoing Michelmersh's recent growth rate.

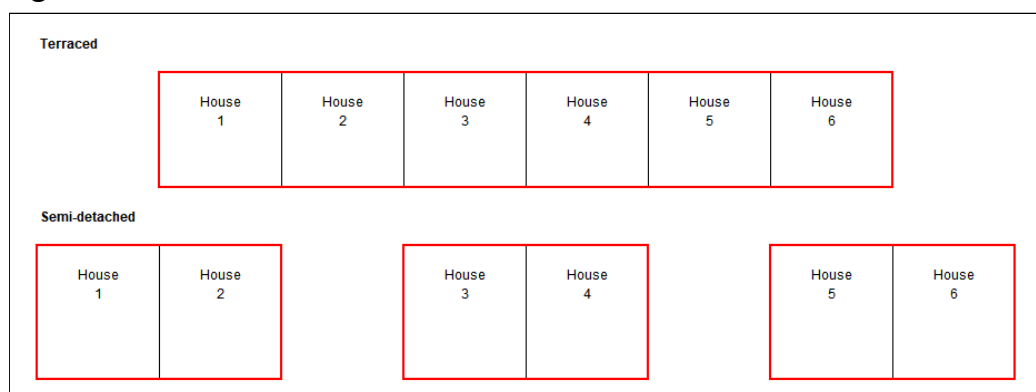
## A flash in the pan?

Will the rebound seen in H1 continue? For now, yes, but running into 2022 there is likely to be a loss of momentum, potentially significantly. While new build demand (new housing is the major user of bricks in the UK) is, in the immediate term, likely to remain in a fairly healthy state, there is likely to be a marked reduction in repair, maintenance and improvement (RMI) spending. Furthermore, once the catch-up development of new homes delayed by Covid has run through, new build demand is likely to slip and revert to a norm. There are also potential, and more fundamental pressure points for new build housing.

The end of Help to Buy (HTB) in March 2023 is likely to follow the classic pattern of a surge and slump (see the 2016 spike in market activity in Figure 4 below – this was the introduction of the stamp duty surcharge on second homes – as an example) followed by structurally lower demand from first-time buyers (FTBs) for new homes. As the various 95 per cent loan to value (LTV) mortgage schemes kick in as partial replacements, new build loses the huge advantages wrought by HTB and FTBs could be more likely to buy an existing home rather than a new one. Total new housing demand could drop.

Another outcome is likely to be smaller new homes bought by FTBs. Under HTB, the notion of a first home shifted from either a flat or two-bed terraced house with a three-bed semi-detached house becoming a more normal first purchase from a house builder. That could easily reverse and drag down brick consumption: in Table 1 below we estimate the impact of a change of new home size (800sq.ft vs 1,050sq.ft) and different configuration (terraced versus semi-detached).

**Figure 4: Terraced vs semi-detached houses – red line = brick construction**



Source: Investors' Chronicle

**Table 1: Brick consumption: terraced homes versus semi-detached**

Terrace of 6 @ 800 sq.ft	No. of bricks	3 pairs of semis @ 1050 sq.ft	No. of bricks
Per home (2 walls)	2,988	Per homes (3 walls)	6,264
Gable ends	2,335	Per pair	12,529
<b>Terrace of 6 homes</b>	<b>22,599</b>	<b>Total for 6 homes</b>	<b>37,587</b>

Source: Investors' Chronicle

New home demand may also drop more broadly as lenders become more risk-averse. After a period of steeply rising prices, lenders fear a step back and loss of security for all homes, but more acutely in new homes because of the so-called 'new-build premium'. A new house is likely to be priced 10-12 per cent higher than the exact same house that is three years old and no longer new. The threat of rising interest rates and tougher affordability tests (it is estimated that higher energy costs could lower the average mortgage offer by £15,000) could dent mortgage demand and lower all housing transactions.

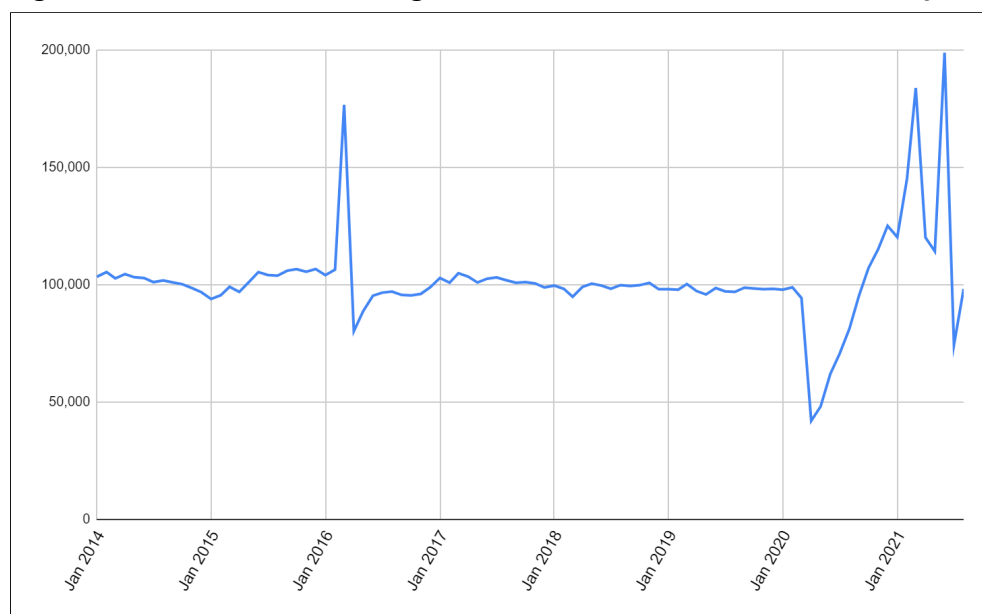
Whatever pressures are faced by new builds, pressures on RMI look more acute: Graeme Kyle at Shore Capital estimates that 35 per cent of brick output ends up in RMI projects (55 per cent in new housing and 10 per cent in commercial/public buildings). For Michelmersh as a specialist brick marker, RMI is likely to be higher (perhaps > 50 per cent). Spending on improvement in the residential market is typically a lagging indicator of housing market activity with home movers spending on upgrades and improvements in the months following occupation. The stamp duty holiday, the Covid-led 'escape to the country' and some elements of post-lockdown catch-up have caused housing activity to surge, reaching almost double the long-run average of 100,000 moves per month in June running up to the end of the stamp duty holiday.

The housing market has run at the 100,000 per month level so consistently that this could be taken to be the market's 'natural frequency' and the level to which activity and materials demand are likely to return. It may, however, trend lower for a period cutting market activity and impacting RMI spending:

- The market surge will have foreshortened demand and left a vacuum.
- Housing is materially more expensive than pre-Covid which could trim the number of viable home movers.
- That same higher price could also limit or delay spending on home improvements.
- RMI costs are likely to rise due to super-inflationary production and distribution costs for many materials.

- Household disposable income is going to be hit by general inflation and tax increases which could defer or delay home improvements.
- Any increase in interest rates in response to inflation would be expected to dampen market activity.

**Figure 5: UK monthly housing market transaction – seasonally adjusted**



Source: HM Revenue & Customs / National Statistics

## Gas prices *et al*

Brick manufacturing is one of the UK's high energy manufacturing processes with all products requiring substantial energy use. Brick and clay roof tiles must be kiln fired, a process that requires one to two days of drying the wet clay at 80°C-100°C and then firing for two to three days at 800°C-1,200°C. Gas is the primary fuel used in brick kiln, but alternatives such as liquefied petroleum gas (LPG), coal, and oil could be used, but are rare. Unlike cement manufacturing, recycled materials such as household rubbish or shredded car tyres cannot be used.

Kiln energy is a major component of manufacturing cost: Aynsley Lammin at Investec reckons that gas is 10 per cent -12 per cent of total cost across the UK brick industry, most likely more for a smaller player such as Michelmersh. Where industrial gas prices will settle or whether the government will somehow intervene is still unknown (but looks increasingly unlikely) meaning that there is a major risk of margins being dented by this cost increase. As with the domestic energy providers, there will have been some hedging and forward purchasing of gas, but it is unlikely that costs will be fully protected in the near term and there will be full exposure to higher costs 12-18 months out.

The UK's brickmakers have already warned that brick list prices into 2022 are likely to rise by 10-15 per cent simply to recover the additional kiln and distribution costs (bricks are heavy and cost a lot in haulage) increases that were already evident earlier in September: ultimate price increases could be higher. This industry has long had strong pricing power with just three players controlling over 90 per cent market share and passing on cost pressures from whatever source has been run-of-the-mill. Michelmersh is able simply to slot in behind the leaders on pricing plus it has some measure of pricing power of its own in that it has very limited competition for its more specialist products.

It may not, however, all be plain sailing when it comes to pushing prices. Industry margins are high (for Michelmersh 41 per cent gross and 26 per cent Ebitda), which does risk push back by larger customers (especially the house builders) and potentially the competition authorities.

## **A naturally constrained business model**

The UK brick market is very well consolidated and offers limited scope for anything other than very small scale acquisitive growth, which makes the brick manufacturers a very cyclical industry. There is some scope to push out at the fringes such as Michelmersh being involved in roof tiles, aerated concrete products and having a small toehold in Europe through Floren in Belgium, but this is limited.

In order to add a true growth dimension, brick makers would need to diversify significantly into long-term growth market segments such as the de-carbonisation of buildings, factory-built housing, smart cities or green construction processes. Such new paths are possible, but there are no signs of such change and it is typically hard to convince the markets that such wholesale changes will be able to deliver and like with the house builders there is something of a mindset of 'we just do this' leading to a reluctance to diversify.

## **Conclusions**

UK brick makers are generally pretty stable businesses with an orderly market and robust pricing power, but they are cyclical and heavily reliant on just one part of the economy. Trading is strong today at the headline level, but much of that is rebound and the true underlying, like-for-like trend is much more moderate. That underlying 5 per cent growth is facing headwinds into 2022 and 2023 and perhaps to the extent that the already moderate growth expected is not delivered – consensus forecast EPS growth in 2023 is just 4.5 per cent. So, the normal positive drivers of upgrades feel unlikely and there is limited scope for corporate activity – the market is too consolidated to allow the leaders to buy Michelmersh and the sector does not feel right for private equity interest.



The shares have derated markedly in recent weeks, down 28 per cent from the high in April, underperforming the FTSE All-Share by 32 per cent over nine months and now sitting 10 per cent below pre-Covid levels. This performance is weaker than the wider materials sector which has only thrown into reverse since the start of September, and has only re-traced 12 per cent. This reflects the higher perceived risk in this sub-sector.

However, even after that fall back, the shares are not especially cheap. The forward P/E and EV/Ebitda are only in line with the building materials sector (at  $14\frac{1}{2}x$  and  $8\frac{3}{4}x$ , respectively), which are both a little above the average for the FTSE 350 index. Michelmersh's yield at 2.9 per cent is below the market average of 3.7 per cent.

Given the relative risk profile of being tied to the housing market and being a high energy sub-sector it feels that the rating should be sub-market, not at a premium and the shares would need to derate further before investors should consider buying.

***Continued on the next page...***

## The Property Franchise Group – the better side of the bad game



Source: FactSet

**The Property Franchise Group (TPFG)** is a small (sub-£100m market cap) Aim-traded holding company that acts as a head franchise holder or franchisor in the estate agency and residential letting markets. This means that TPFG owns, markets and provides central functions for nine estate agency brands (Martin & Co, Hunters, CJ Hole, EweMove, Parkers, Ellis & Co, Mullucks, Whitegates and Country Properties) spanning the whole of the UK mainland through c.450 high street branches and >150 'territories' within the online agency EweMove.

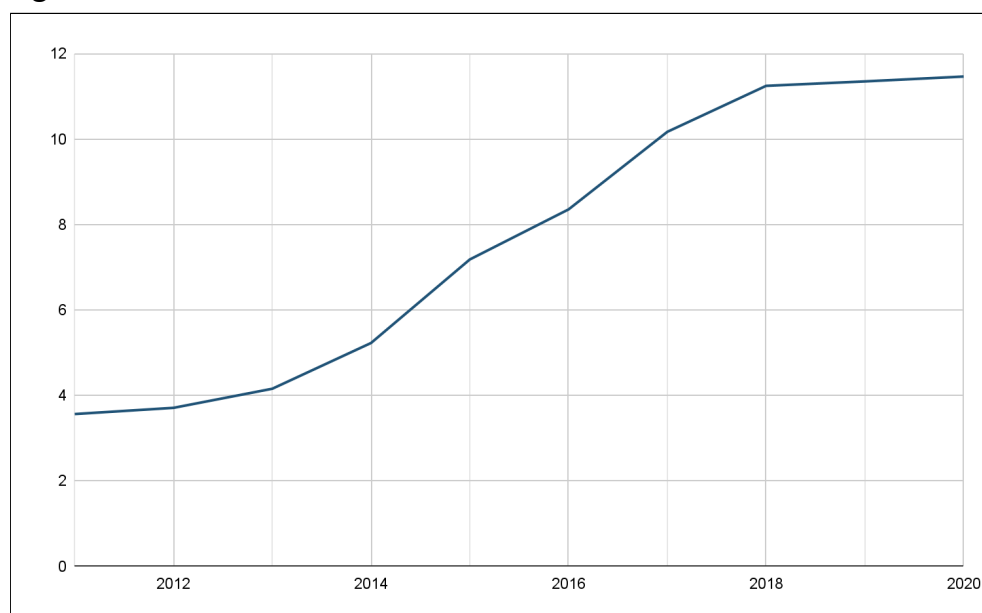
Direct competitors are primarily Belvoir (UK Aim listed) with 170 branches, LSL (UK premium listed) with c.150 franchised outlets and Winkworth (UK Aim listed) with 130 offices.

The model is to sell local, small (often single outlet) estate agents the right to use one of the brands and then to collect various revenue streams from those businesses' typically increased revenues. In rare cases, a 'cold start' franchisee will be permitted to invest. TPFG derives its revenues from a number of sources:

- **Upfront fees** payable once on the sale of a franchise, typically around £15-20,000.
- **Management service fees (MSF)** calculated at 9 per cent of the franchise revenue from sales, letting and related activities: this is payable monthly and is usually subject to a minimum payment level.
- **Central marketing fund:** holders contribute a small percentage (1 per cent to 2 per cent) of their revenue into a central fund to provide marketing services across all brands.
- **Software or platform sales** to ensure a common standard and systems across the brands.

TPFG's performance in recent years had been fairly indifferent with flattening revenues pre-Covid after more than five years of solid growth: this suggests that the brands had become saturated. A transformative acquisition was made in March this year when fellow UK-listed franchisor Hunters was purchased for £26m, adding two brands and 210 outlets (200 of which were franchised).

**Figure 1: TPGF's historic revenues in £million**



Source: Factset

This deal breathed new life into this business with immediate earnings accretion due to shared overhead elimination, cancellation of plc costs, better leverage on centralised systems, raising the MSF on Hunter's franchisees from 8 per cent to 9 per cent and a large number of practical synergies related to the substantial increase in scale: revenues are expected to more than double on a full year basis to a run rate of £25m-£26m. It is

important to note that Hunters had experienced the same revenue stagnation as TPFG but for longer, with no material increase in its income since 2016. In that time, reported EPS dropped by just over 20 per cent. In 2020, however, costs were cut and despite lower revenues, Ebitda grew by 25 per cent. This cost reduction did look long overdue and the margin increase as a result of it might be very hard to repeat.

This similarity of a stagnating model is interesting and shows that deep down, while running franchised estate agents rather than direct ownership is more defensive and less volatile, the only way to grow the core model is by hefty expansion. The combination with Hunters should see growth return for a few years, but without adaptation of the core model there must be a risk that stagnation will return. While there are businesses today for TPFG to acquire in order to kick start growth again, that may not be the case in three to five years' time.

Estate agency is a very high operational gearing business so will have been rocketing in 2021 and despite having a different and less volatile revenue model than direct ownership, a surging market does still cause spikes and slumps in trading. In its recent half-year results, TPFG reported like-for-like revenue growth of 37 per cent driven primarily by growth in the MSF. This may sustain through H2 but in a market returning to, or possibly below, recent levels in 2022 and 2023 MSF revenues per franchisee could drop.

## Looking for more sustainable growth

So what is TPFG doing to reduce cyclicalities and target fresh growth?

- **Lettings** – residential letting is significantly more stable than house sales and TPFG is keen to drive its franchisees to have a greater balance of lettings in their operating models. To help this along, the plc is assisting franchisees buy rental portfolios (the management contracts, not the assets) from other local agents and/or investors.
- **Financial services** – while franchisees are free to offer financial services at a local level, there is very little centralised resource that TPFG can make available and sell through at the branch level. To date, only around 5 per cent of group revenue has come from selling mortgage and related financial products. To grow here, a strategic alliance has been formed with LSL to access its PRIMIS platform to feed additional services and create an extra revenue source. In addition, an 80 per cent stake was recently taken in Mortgage Genie, a mortgage broker established on the LSL platform – this was small beer, only costing £400,000. TPFG aims to have 100 financial consultants by the year end (for scale LSL has almost 2,800).

- **EweMove expansion** – EweMove is a virtual estate agent presenting as a little like Rightmove, but with real people and something akin to PurpleBricks in that there are no physical offices but it charges a percentage commission (1 per cent) rather than a fixed price charge whether or not you sell. A USP is that you can speak to a real person to set up a home sale or arrange a viewing 24/7. EweMove is expanding fast, adding 47 outlets since the start of 2021 (from 95 at the end of 2020) and is targeting another 80 by the end of 2022. Establishment costs are very low as there are no premises, there is an established web presence to slot into and a pre-built centralised IT system. On a visit to the EweMove website, we noticed that the default setting is to show houses that are already sold (350 including the sold units but only 31 unsold) and to offer a very wide and possibly overlapping range of listings with nearby 'territories'. It is not clear how much additional revenue this might bring in.

## Conclusions

While running franchises for the estate agency industry is a more stable model than direct ownership, it is not totally free of volatility and cyclicity as the underlying business served is itself highly volatile. We have also seen in both the core TPFG and the acquired Hunters businesses that there can be a total loss of momentum in the agency business, although this can be helpful as a catalyst to give impetus to the need for a better and broader business model. Although there is a drive to add financial services revenue, the focus here is still narrow and is on a business that the equity markets view as being of fairly low quality.

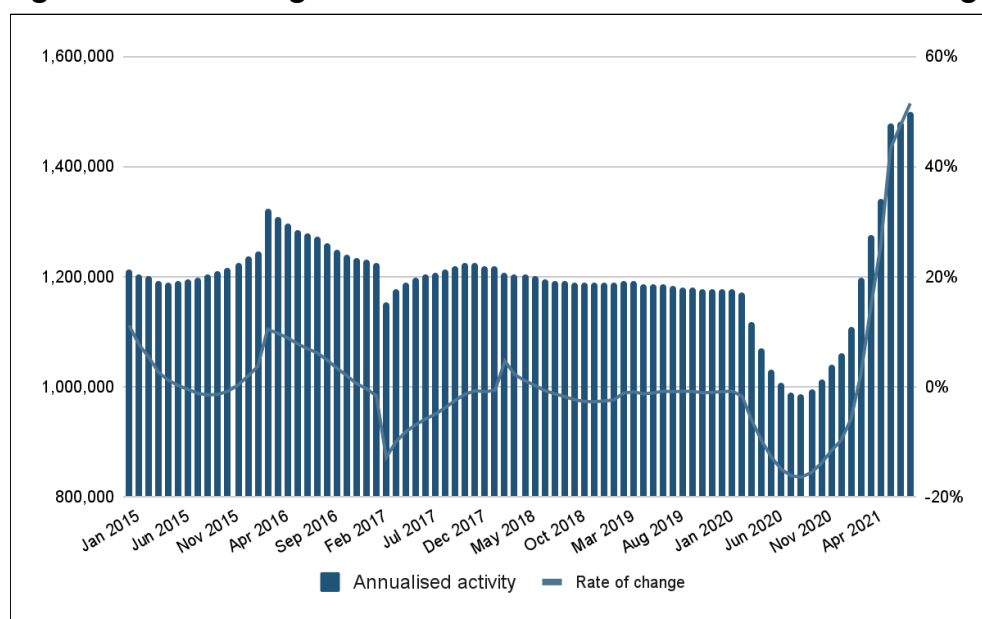
Some credit should be given for the marriage value that the combination with Hunters brings, looking to growing lettings and adding in new revenue streams from financial services but the rating, while looking relatively low against the wider market at around a one-year forward PE of 12x, that feels about right for the make up of earnings here. There was some excitement recently as the dividend level was increased, restoring the historic 50 per cent payout ratio but the forecast yield is only in line with the market average at around 3.5 per cent with limited scope to go higher.

Trading is strong at present due to the strength of housing market activity as is clear from Figure 2 below. However, as Figure 3 shows, the market is past its peak momentum (reached in Q2) and is reverting to normal. As Figure 4 shows, even if Q4 reverts to the long-run average of c.100,000 monthly transactions (as it did in August – the first month reasonably free of the stamp duty distortions), 2021 will see a 40 per cent pick up against 2020.

Projecting that monthly activity level forward into 2022, next year would be 17 per cent less active than 2021 before any negative drag from National Insurance rate hikes, rising mortgage rates, increased domestic energy costs and any wider inflationary drag. For any business tied to housing market activity, 2022 is going to be a tougher year and there is a risk that forecasts still reflect too much the strength of 2021 and map too much of that forward.

TPFG can also look like a stock with good momentum, which can draw in some investors. The rally in the share price primarily reflects a step change correction because of the Hunters deal, albeit a step change in slow motion. That is a once-off rebasing of the share price and does not constitute momentum that should be chased.

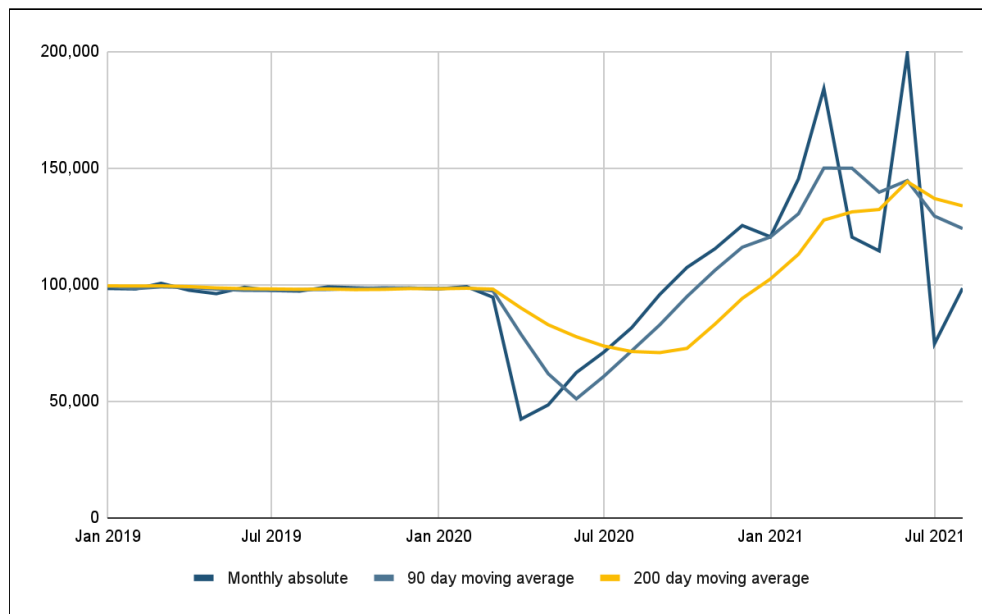
**Figure 2: UK Housing market – annual transactions and rate of change**



Source: HM Revenue & Customs / National Statistics

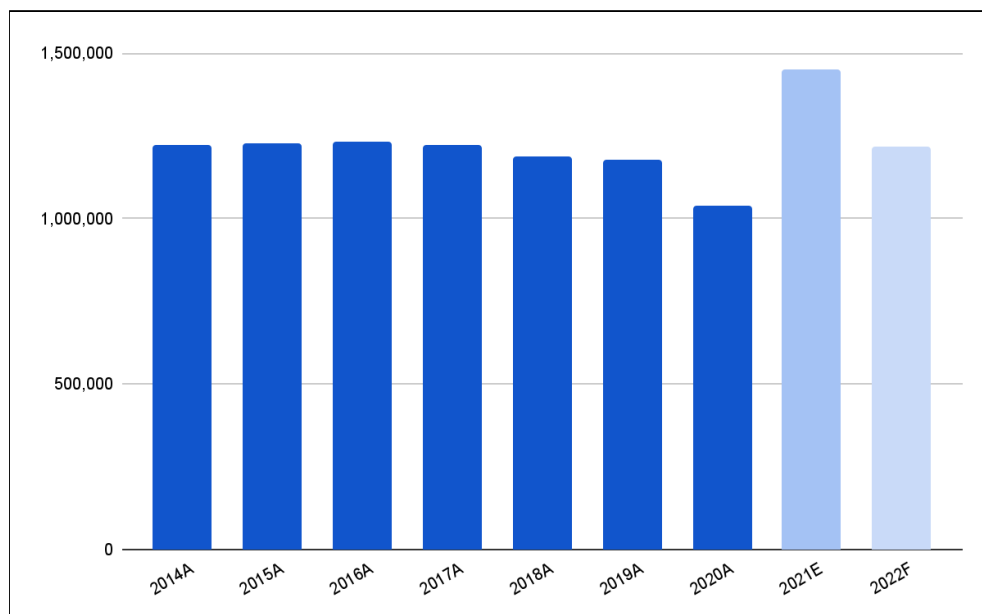
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**Figure 3: UK Housing transactions: momentum**



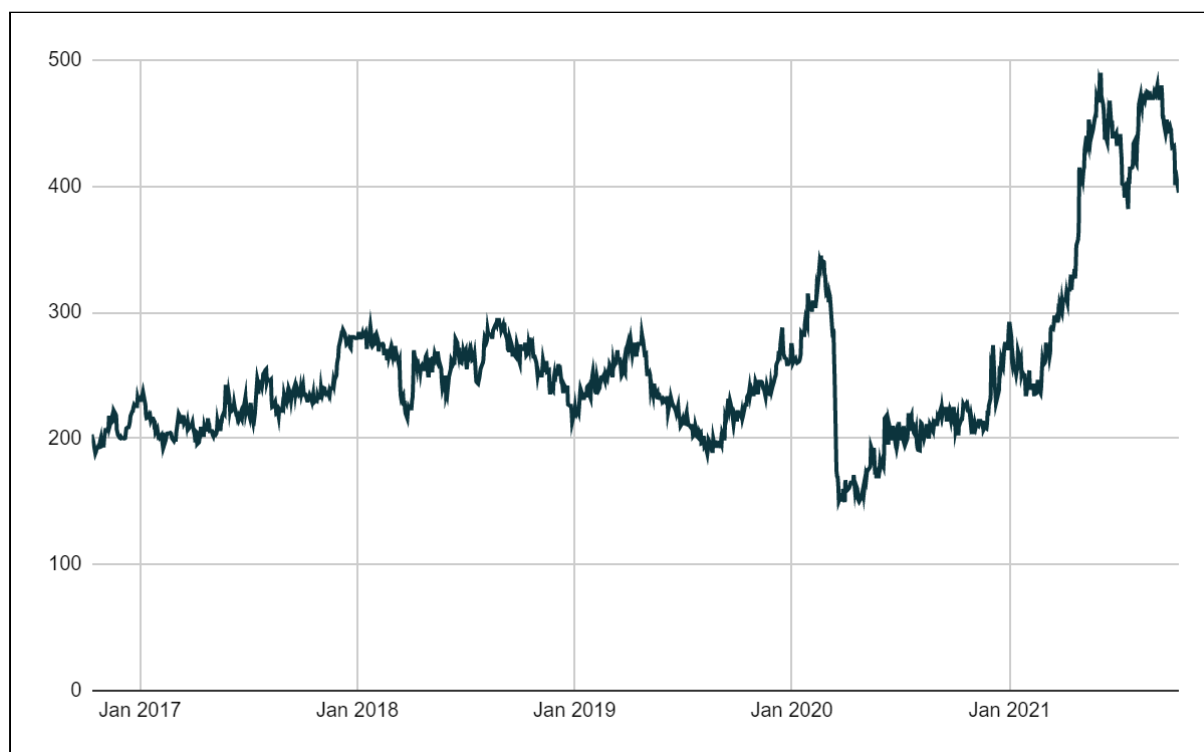
Source: HM Revenue & Customs / National Statistics

**Figure 4: UK Housing transactions: annual rates of activity**



Source: HM Revenue & Customs / National Statistics | 2021 is a composite of actual & forecast | 2022 is a forecast

## LSL Property Services – changing its spots



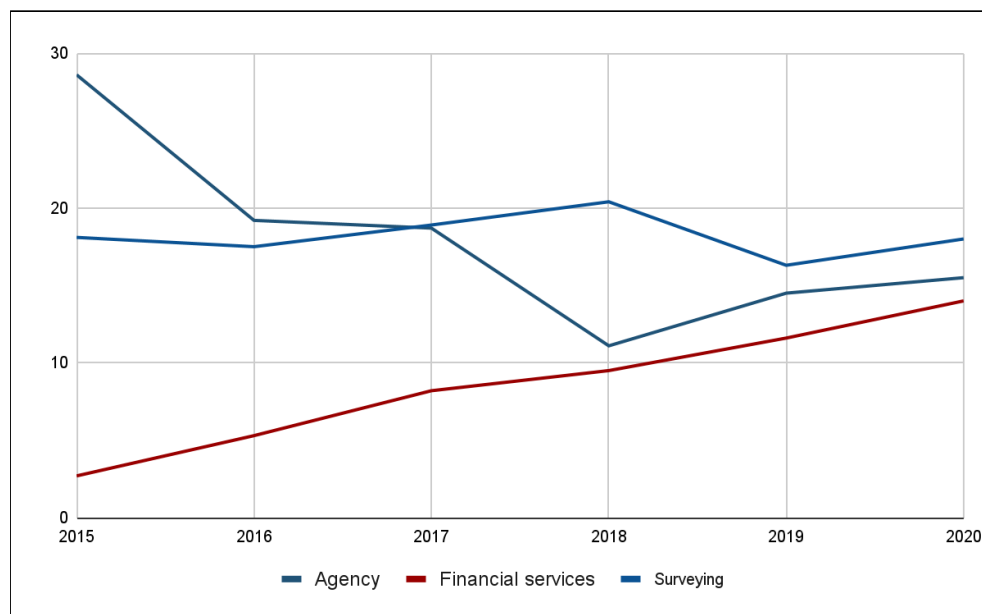
Source: FactSet

**LSL Property Services (LSL)** is also in the estate agency business, but operates a more traditional model of direct ownership with revenues arising primarily from commissions and fees rather than franchise charges (it does run some franchised branches) plus substantial flows from allied business areas. Thus pure agency revenues are more than £120m per annum. LSL's allied businesses are surveying (primarily e-survey) with around two-thirds the revenues of estate agency and a financial services arm selling mortgages and income protection products, which has similar sales to the surveying arm. In 2020, all three businesses reported a similar underlying Ebit in the mid to high teens range of £m.

These businesses have seen very different trading patterns in recent years with relative stability in the surveying operations and the predictable feast and famine in the agency arm. The financial services arm has been the growth feature of the group for many years, but prior to 2019 was a subdivision of an estate agency. It is now a separate reporting line and, as we explore below, has become the focus and driver of the business. As shown in Figure 1 below, financial services has been the most positive operation delivering 26 per cent CAGR since 2016 while surveying has delivered no growth and estate agency has dropped an average of 5 per cent per annum in that time.



**Figure 1: Divisional Ebit trends within LSL**



Source: LSL

**Estate Agency** – LSL's large range of brands makes it one of the largest chains of estate agents in the UK. There is some debate within the industry as to who is the largest with PurpleBricks claiming the largest number of transactions, but it does not have a high street presence and its numbers are somewhat opaque.

On the high street Connells (owned by Skipton Building Society and which now owns Countrywide) has more than 1,000 branches. In 2019, LSL made the bold move to close 124 (of c.400) of its branches eliminating around £50m-£60m of revenue leaving it still a material player, but substantially smaller than Connells. This was a first step in the drive to de-emphasise estate agency within the group. Estate agency is not a well-regarded business in stock market terms as it is highly cyclical and has high fixed costs which lead to high operational gearing. In 2018, for example, agency operations made less than one quarter of the Ebit it had made in 2014 despite reporting 13 per cent higher revenues.

Also when markets slow (as is likely into 2022) estate agents have a history of cut throat discounting on commissions to try to boost local market share, but such price fighting has tended to stick and agency commission rates look to be in steady decline. According to a survey by the Advisory Group the average sales commission today is 1.18 per cent, down from 1.42 per cent in 2018 and 1.6 per cent in 2011.

Fixed fee agents such as PurpleBricks or Yopa have put acute pressure on agents' fee levels – PurpleBricks charges £999 (£1,499 in London), which saves a seller £2,000 on

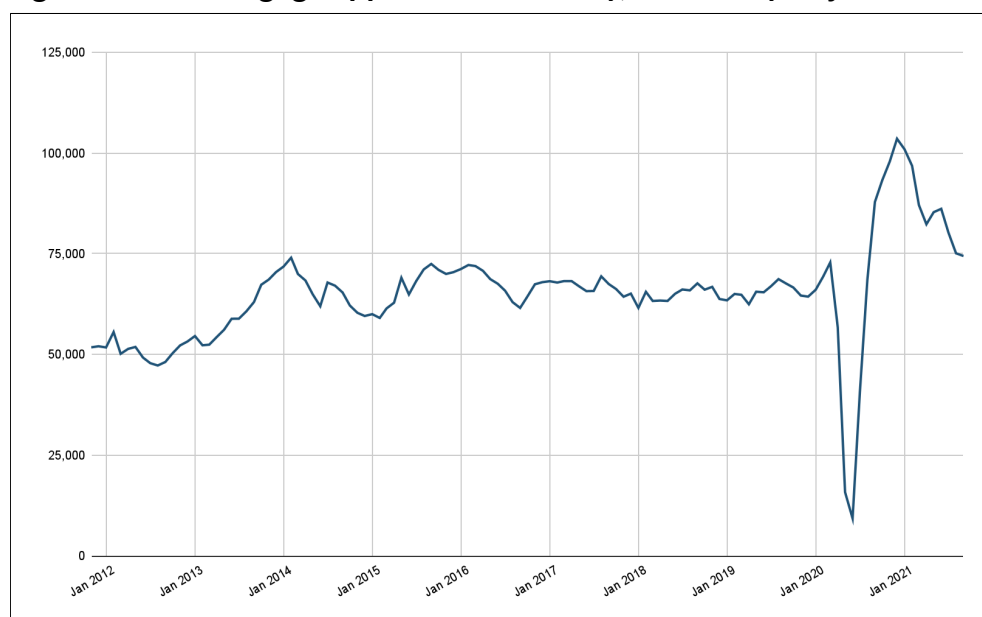
the UK's average priced home or £10,000 for a £1m home in London. The jury is still out, however, on the relative value propositions of physical versus virtual estate agents.

In the current year, that operational gearing has swung back into the group's favour and in H1 revenues rose by 47 percent and margins pushed back above 10 per cent, making the agency the largest profit centre in the group. The board has warned, however, that this period is likely to be a high water mark for the agency operations and the operational gearing will act in reverse again in H2 and perhaps into 2022.

As with many agents, lettings provide a more stable backbone, less profitable but higher quality than commission income from property sales. Across the cycle lettings fees and commissions each varied between 45 and 55 per cent of total agency revenues, but reflecting the surge in house sales, it had dropped to just 43 per cent in the 2021 half-year results.

It is clear that the agency business will not be the focus for the group going forwards with very modest aspirations to nudge up market share, grow franchising income and push up the financial services revenues. LSL does not want any longer to be viewed as an estate agency business and it is notable in its presentations that data on the agency side is now reported last with financial services given top billing.

**Figure 1: UK mortgage approvals – monthly, seasonally-adjusted**



Source: Bank of England BankStats

**Surveying** – LSL, through its e-surv brand, is the UK's largest valuations surveyor. It offers only basic valuation surveys for lenders (for mortgage approval purposes) with

revenue per survey running out at around £170, although it does make a 20 per cent margin consistently on that income. This is still a business tied largely to the cyclical nature of the housing market, but slightly less so than agency due to some demand from the remortgaging market. As has been the trend for the last five years, there is essentially no growth in this part of the market and this is a relatively low grade business as it stands.

To drive some growth through this arm of its operations, LSL is looking to broaden more into the B2C market to offer house purchase reports, full structural surveys, energy efficiency reports and cladding surveys. Even moderate inroads into these other fields would help to inject something akin to growth into this division for several years and should raise the quality of earnings.

While valuation reports can command as little as £100, a buyer's condition report might cost £250 (a quick sketch only), a home buyer survey (a reasonably detailed report on condition) might cost £600-£800 and a full structural survey £900-£1,200. According to Churchill Insurance, the number of buyers paying for additional inspection reports is on a slow steady decline, but the numbers are still material. Around 1.2m homes are bought and sold each year and some 17 per cent have a basic condition report, 13 per cent get a home buyer's report and 6 per cent have a full structural survey. It is notable that 20 years ago, one quarter of home buyers paid for a full survey.

All told, these additional direct-to-consumer surveys generate total annual fee income of £200-£300m almost none of which comes to LSL. Using its position as the largest employer of RICS qualified professionals in the UK, there is scope to add a material amount of additional revenue and profit.

**Financial services** – this is where LSL sees its future, driving up both profitability and the perceived quality of earnings. There has been a long involvement with housing-related products previously in a tied-up capacity within the estate agency, but now operating on a more arm-length basis with the whole market. The scope, structure and ambition of this part of LSL can be compared with the activities of **Mortgage Advice Bureau (MAB)** with its business driven by its PRIMIS platform, which is very similar to MAB's MIDAS. This allows independent financial advisers access to products, information, 'sweetheart' deals, administration services and, most importantly, regulatory cover and compliance. This removes a significant amount of administrative time and cost and allows the adviser to focus on selling.

These operations have shown strong organic growth (see above) and in terms of active advisers, LSL is larger than MAB with c.2,750 active advisers versus MAB's 1,700. In its last full-year LSL brokered £33bn of mortgage value against MAB's £18bn.

LSL's revenues are lower than MAB's, indeed around half, suggesting that LSL has been operating in more of the commodity end of the advice market. There is, however, a drive to change the scale and quality of its operations through the £200m joint venture formed in April with Pollen Street Capital called 'Pivotal Growth'. LSL has invested £33m, Pollen doubled that and the balance came through leverage. The ambition is to become the "leading national mortgage broker powered by market leading technology, first class regulatory compliance and exemplary customer service".

LSL believes that its £200m of deployable capital could buy (and expand) 50 small intermediary businesses and, based on prices paid by the likes of MAB (20x earnings), that could buy £10m of post-tax profit. With synergies and overhead savings that might run, in time, to £15m. If delivered, that is significant because existing post-tax profit in financial services is only around £11m; LSL's 48 per cent stake could chip in c.£8m to group earnings.

This sounds fine on paper but MAB suggests that the nature of the advice market is changing and moving away from local, in person advice to centralised, farmed out leads generated from the likes of comparison websites and other proprietary technology that identifies potential customers. If that is right, investing £200m in local expertise, contact and leads would not necessarily be money well spent. However, it is impossible to be certain today which path the mortgage advice industry will follow.

## Conclusions

Shifting the axis of your business away from a lowly rated activity such as estate agency is a positive move and the very act of no longer wishing to be known as an agency business could/should improve a stock's rating. That said, profits from the group are likely to remain volatile and even with the objective of limiting agency operations to 25 per cent of the group, swings in this division's earnings still risk derailing good growth in the better parts of the group.

The drive to bolt on a higher value direct-to-consumer service in the surveying arm is a significant positive and should turn a flatlining business into one capable of at least high single-digit growth for several years.

Growing the financial services business is the game changer, however. Faster expansion in what is already the most dynamic part of the group has scope to push up the growth rate and improve the rating. While there is a good comparison to be made with MAB, this part of LSL does feel lower quality so it would be wrong to map across MABs 30x P/E (and also because MAB still feels over-rated by around 20 to 25 per cent) when looking at valuation.

The board is confident that it can deliver £60m of Ebit overall in FY2023 and that does not feel like too much of a stretch with the drive for change and a baseline profit from 2020 of £41.5m. What sort of valuation might that suggest? The market's view seems to be that that £60m would split, according to Chris Millington at Numis, 40/35/25 per cent for Financial Services, surveying and agency. Applying sensible multiples we might get a sum-of-the-parts as follows:

**Table 1: New structure LSL sum-of-the-parts (SOTP)**

	EBIT in 2023	Post-tax	Fair value PE	Fair value
Financial services	£24.0m	£18.0m	14.0x	£252.0m
Surveying	£21.0m	£15.8m	11.0x	£173.3m
Agency	£15.0m	£11.3m	6.0x	£67.5m
	£60.0m			
Net cash				£60.0m
Overall fair value for LSL				£552.8m
<b>Per share fully diluted</b>				<b>523p</b>

Source: Investors' Chronicle, Numis

This valuation has to be viewed as a 'best possible outcome' and comes with caveats, primarily that the housing market may run out worse than expected, changes in surveying may take longer and the approach of buying local specialists in financial services may fly in the face of alternative evolution of the sector. Also, any SOTP calculation will tend to overstate a deliverable equity valuation.

That said, with the share price having just recovered from below 400p there does seem to be some value here. However, until the market can be better convinced that change is coming, the shares may continue de-rating through concerns about the housing market, higher personal tax, the threat of higher interest rates and pressure on household incomes. There is likely to be better value in the coming weeks here, so while this does look like a compelling investment story, there is a good chance that the shares can be picked up more cheaply than today, but LSL is certainly one to watch.

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