VALUE.ABLE **Roger Montgomery**

SECTOR CONSTRUCTION

It's tough on the home front

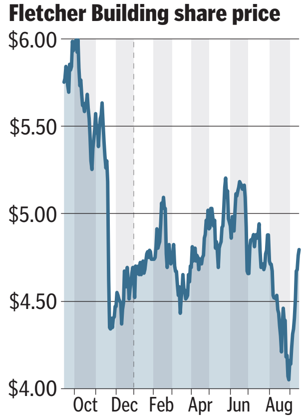
Conditions in residential building are likely to get worse before they get better

Between 2012 and 2016, mortgage lending standards were relaxed, fuelling a boom in domestic property investing. Together with a surge in offshore buying interest, the boom led to oversupply and frequent warnings from your columnist. The oversupply is now hitting the property market at the same time that bank lending standards have been tightened, property prices are falling, quality has been found wanting and building approvals have plunged.

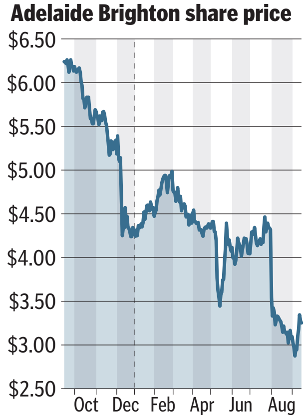
While it's true that auction clearance rates are rising, the fact remains that the economy needs more residential construction, not the sale of established dwellings. More importantly, national new "for sale" listings for the 28 days ended September 1 were down 16.8%.

The sharp decline in building approvals will be followed by a sharp decline in construction activity as builders complete homes that were ordered a year or so ago. There is simply going to be a lot less new work, if approvals for future buildings are already a third lower than they were a year ago.

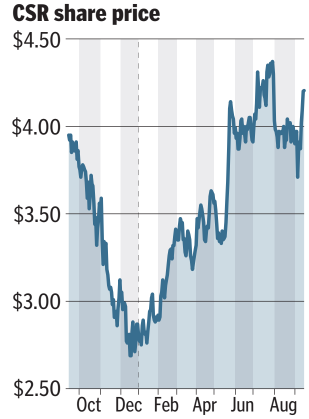
Fletcher Building share price



Adelaide Brighton share price



CSR share price



Because the residential construction industry employs 3.5% of Australia's workforce, the lower incomes to be earned by chippies, sparkies, plumbers, brickies, tilers, painters and plasterers will be felt by the economy – sufficiently for the Reserve Bank to be worried. Hence, the cut in interest rates.

But whether a mortgage is set at 3.5% or lowered to 2.9%, rate cuts aren't enough to offset declining incomes, poor quality and oversupply to spur buyers to order new homes. No wonder the RBA is asking the government to spend more on infrastructure.

For companies directly exposed to new home construction, conditions might become tougher before they improve.

Roger Montgomery is the founder and CIO at the Montgomery Fund. For his book, Value.able, see rogermontgomery.com.

❶ Fletcher Building

ASX code FBU
Price $4.78
52wk ▲ $6.05
52wk ▼ $3.99
Mkt cap $4.1bn
Dividend 18.5¢
Dividend yield 4%
PE ratio 26
■ **SELL**

Fletcher generates a third of its revenues from a portfolio of businesses including Tradelink plumbing and bathroom supplies, Iplex pipes, Rocla concrete and Stramit steel. The recent sharp decline in the residential market saw earnings before interest and taxes (EBIT) fall 50% in 2019. Fletcher is now cutting costs to stabilise the business. Cutting costs should be a daily discipline, not part of a "restructuring", and returns on equity are in single digits, suggesting the balance sheet assets might be overvalued.

❷ Adelaide Brighton Cement

ASX code ABC
Price $3.24
52wk ▲ $6.24
52wk ▼ $2.85
Mkt cap $2.1bn
Dividend 28¢
Dividend yield 6%
PE ratio 26
■ **SELL**

About 30% of Adelaide Brighton's revenues is generated from residential housing activity. Half-year revenues fell 6.3% to $755.7 million and net profits fell to a loss of $17.9 million compared with a profit of $84.5 million for the previous corresponding period, highlighting operating leverage. While management is hopeful of offsetting strength from mining and infrastructure, we note iron ore prices are falling, as are the share prices of large materials companies.

❸ CSR

ASX code CSR
Price $4.19
52wk ▲ $4.41
52wk ▼ $2.62
Mkt cap $2.1bn
Dividend 26¢
Dividend yield 6%
PE ratio 27
■ **SELL**

CSR produces Bradford insulation, PGH bricks, Gyprock plasterboard and Hebel precast concrete blocks, reflecting the company's exposure to residential construction. The building products division fully participated in the construction boom, with net sales up almost 60% between 2013 and 2019. The decline in residential building approvals, however, will have the reverse effect and operating leverage may also impact margins.

Prices as at ASX close of business, 13-Sep-19.