A dominant market position, attractive industry structure, and vertically integrated business model make Ibstock—the UK's leading clay brick manufacturer—a clear beneficiary of an expected pickup in housing activity.

In the United Kingdom, approximately 75% of housing facades are made of brick[1], and Leicestershire-based Ibstock is the country's #1 manufacturer of clay bricks[2], with a supplemental portfolio of five well-known concrete brands that cater to construction end markets.

Ibstock's business is levered to residential building activity in the UK, and with housing starts down sharply in recent quarters, the company's top and bottom lines have, unsurprisingly, come under pressure. We believe that Ibstock, given its dominant market position, flexible cost structure, and vertical integration, is among the best-positioned building materials companies to capitalize on an anticipated rebound in UK residential construction—an eventuality that we do not believe the market is appropriately pricing in.

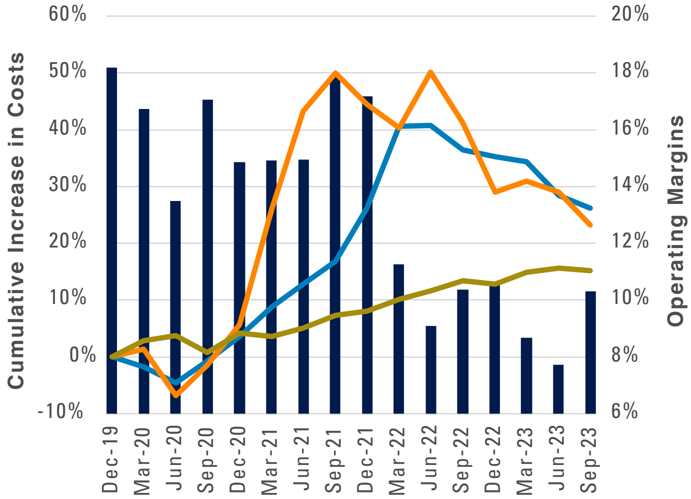
THE UK HOUSING DOWNTURN

At the end of 2021, the Bank of England began rapidly hiking its policy rate to combat inflation. UK mortgage rates rose in concert, with the 5-year fixed rate peaking at 5.7% in the summer of 2023, up from 1.3% in late 2021[3]. At the same time that mortgage costs were surging, UK real wages were plummeting, along with the near-term prospect of homeownership for millions of Britons. In 2023, with housing affordability at its lowest in nearly 15 years[4], the UK government unveiled new building standards, prompting a massive pull-forward of construction to get ahead of the regulations (Exhibit 1, June '23 quarter). What naturally followed was a major drop-off in new builds, and with the lack of affordability sapping demand, developers have had little incentive to ramp up construction since.

		Earnings Per Share			Price/Earnings		
	Price	FY24E	FY25E	Normal*	FY24E	FY25E	Normal*
Ibstock	£1.86	£0.08	£0.11	£0.23	23.5x	16.9x	8.1x

*Fiscal quarter-end September 30. *Pzena estimate of normalized earnings.*
Source: FactSet, Pzena analysis. Data as of September 30, 2024

Exhibit 1: New Builds Plummet



Source: UK ONS

Consequently, UK brick deliveries collapsed, falling nearly 30% year-over-year in 2023, and by our estimates, they remain approximately 20% below-trend today

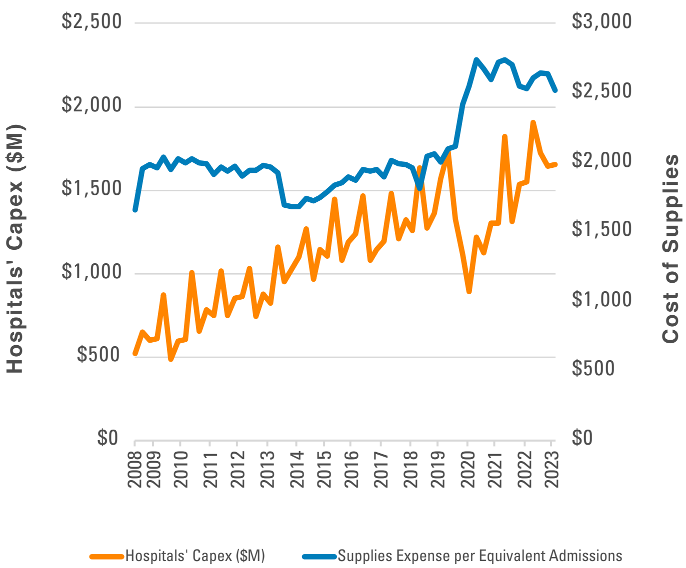
INDUSTRY RESILIENCE

The environment has been undeniably challenging for UK brickmakers, but an attractive industry structure has insulated Ibstock from further financial pain. Ibstock, along with peers Wienerberger and Forterra, maintains a roughly 90% market share in what is effectively an oligopoly—the result of decades of market consolidation. The industry also has very high barriers to entry, given the massive capital investments and permits required, while foreign brick imports come with especially high transportation costs.

1. Brick Development Association
2. Company filings
3. Bloomberg
4. Bloomberg, relative mortgage cost = mortgage payments as % of mean take-home pay (first-time buyers)

During the 2008–09 housing collapse, the industry responded by taking a significant amount of capacity out of the system. As the market rebounded, domestic demand began to outstrip available supply around 2014, and the shortfall had to be filled via expensive imports, which peaked at about 23% of demand in 2022[1] (Exhibit 2). Imports have since begun to normalize lower, which we expect to continue, while domestic brick capacity today is more aligned with a normal level of demand, supporting structurally higher margins for Ibstock.

Exhibit 2: UK Brick Supply and Demand



Source: Redburn Atlantic

Most importantly, the trio have remained exceptionally disciplined on price amid the pronounced volume drop-off, being unwilling to undercut one another for market share gains at the expense of margins. This is a major reason Ibstock was able to post a 33.8% adj. EBITDA[2] margin for its clay business in 2023, down just 50 basis points from the prior year, despite deliveries falling approximately 30% year-over-year[3].

EARNINGS INFLECTION

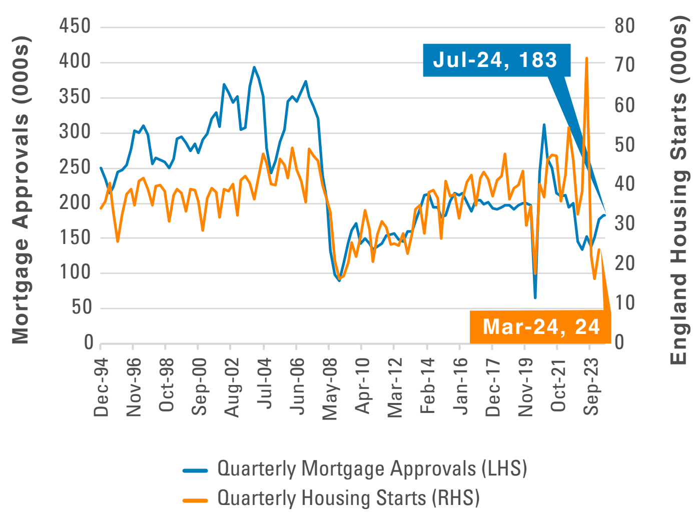
In contrast to Ibstock's core Clay business, which is mostly exposed to residential housing, its non-core Concrete unit has more diversified end market exposures (rail & infrastructure, fencing, elevator shafts, etc.), which is a key reason the segment's FY24 sales are expected to be up year-over-year. That said, Concrete only accounts for approximately 12% of our normal earnings estimate, so Ibstock's re-rating is contingent on the Clay business normalizing.

1. Redburn Atlantic, ONS
2. Earnings before interest, taxes, depreciation, and amortization
3. Company filings

There are two aspects to Ibstock's Clay earnings recovery, in our view. One is cyclical and market-driven, while the other is more company-specific. After underbuilding for decades, the UK needs homes—a lot of them. Britain's housing deficit now stands at an estimated 4.3 million homes, while population growth is outpacing housing completions at the steepest pace since the 1940s, according to Bloomberg.

In response to the glaring housing shortage, the new UK government is aiming to build 300,000 homes per year in England over a five-year period. This is an extremely ambitious target, considering UK builders have not added that number of dwellings in a calendar year since the 1960s[4]; however, it is directionally positive insofar as the government is actively trying to tackle this increasingly acute issue. At the same time, mortgage rates have been declining, which should materially improve housing affordability and thus, barring a major recession, demand. This is already showing up in the data, as UK mortgage approvals, which are positively correlated with housing starts, have been steadily rising for the past 10 months[5] (Exhibit 3).

EXHIBIT 3: MORTGAGE APPROVALS ON THE RISE



Source: Bloomberg, ONS, Bank of England
**2Q24 housing starts data has yet to be released*

The implication is that UK brick demand is slated to rise materially from 2023's depressed level of 1.7 billion, which is roughly 600 million below the average between 2000 and 2022[6]. We are conservatively modeling total UK demand of 2 billion bricks by 2028, which is underpinned by an estimated 150,000 housing completions—well below both the government's target and 2019's level of 177,000[7].

4. ONS
5. Bloomberg, ONS, Bank of England
6. Redburn Atlantic
7. ONS

On the company-specific front, we believe Ibstock's vertical integration and operational flexibility are paramount to its long-term earnings power. Ibstock operates 32 clay and concrete manufacturing plants (all in the UK) and owns 73 million tons of clay reserves[1] in close proximity to its facilities, providing it with long-term, strategic access to its key input. Ibstock's supply chain advantage is a major reason it has maintained above-industry operating margins, and we expect that to persist through the current cycle.

We also expect Ibstock to continue replacing high-cost capacity with cheaper production, resulting from years of investment in state-of-the-art facilities. While Ibstock's growth spending is beginning to

wind down, the benefits of a higher-quality asset base have yet to show up on the P&L statement, and we believe the market is not appreciating the prospect of a structurally higher margin profile once volumes normalize. In the interim, Ibstock's strong balance sheet should enable it to weather the current downturn without the need for additional capital.

CONCLUSION

In our view, Ibstock is the quintessential value stock: an excellent franchise operating in a consolidated industry that is experiencing cyclical—but temporary—pain. The stock's solid performance in the third quarter is a reflection of investors' rising expectations of a top-line recovery; however, we believe this represents only a fraction of the anticipated multi-year earnings improvement conservatively underpinned by a normalization of housing starts and modest margin expansion. We believe Ibstock's normal operating profit is approximately twice this year's expected level of £44M, which equates to approximately 8.1x our normal earnings estimate.

1. Company filings

FURTHER INFORMATION

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Ibstock was held in our International Small Cap Focused Value strategy during the third quarter 2024.

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