

Home Builders: What's Different?

Introduction

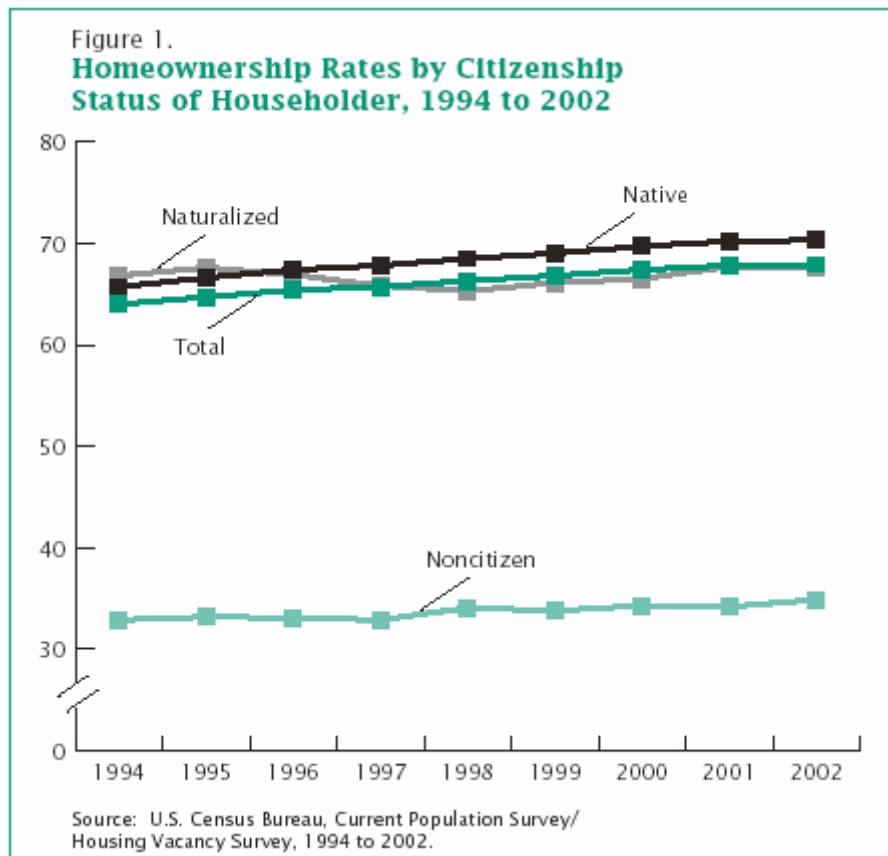
In the home builder sector of the market there is an ongoing debate on whether things are different this time or not. Investors who have taken the pro side in these debates in the past have been burned, and they are justifiably wary now. So, what is different this time? Are changes in the industry significant enough to matter? After the stunning run-up in share prices, are home building stocks over valued? If things are different, is it the right time to invest?

When I first looked at home builders several years ago, I felt their margins were too low and did not fully understand the implications of the business model. Today I see improved margins and a business model that has many very positive factors. Whether the industry is assessed by reviewing valuation ratios or from a top down strategic analysis, the story is compelling. However there are some important factors to consider that will not be different during the next housing downturn.

With home builders the investing strategy relates to the whole industry. There are many stocks worth buying. Since the industry has a relatively small number of mid-cap stocks, you can create your own low cost, "Personal-ETF" and gain exposure to a reasonable percentage of the entire industry.

One Big Difference

As mortgage rates declined in the 1990's home builders provided a supply of low-cost, quality homes for first-time buyers. This has allowed U.S. homeownership to rise from 64.0 percent in 1994 to 67.9 percent in 2002 as shown by the U.S. Census chart at right. This increase in home ownership rates has in turn fueled the home builder's profit engine. At the core of the "It's Different This Time" debate is the question of whether or not this trend can continue for much longer.



Other Important Differences

Development and refinement of a high-profit business model is another big difference. The industry operates in a market where there is no foreign competition, the market share of current corporate competitors is small, the percentage of home ownership has been going up, and future market share can come at the expense of inefficient small companies rather than other corporate home builders. In addition to the broader market factors there are other factors that give corporate home builders a competitive edge over their smaller competitors. The permitting process will probably not get easier, and large home builders can better afford the staff and systems to speed the process and cut costs. The larger builders can also provide one-stop shopping in the form of packaged financing and many model choices. Those involved in the debate are at odds as to whether these factors improve the ability of home builders to endure future economic downturns.

When the next downturn occurs, the companies with strong free cash flow and solid balance sheets should be able to withstand it better than their smaller competitors have in the past. With experienced management teams in place these companies are now employing economies of scale and improvements in construction quality that will be difficult to compete with in down markets. By investing in several home builders with good fundamentals while times are good it should be possible to connect with at least one management team that gets it right in the long run.

Will The Differences Matter?

Sooner or later one of two things will happen to rain on the current parade of profits. Either interest rates will rise high enough to choke off new home financing, or joblessness will increase to a point that the number of people able to afford a home declines significantly. The well financed companies should be able to survive a round of high interest rates. Even though The Fed continues to pump liquidity into the economy, the specter of inflation haunts modern economic thinking. When inflation finally starts to appear, The Fed will raise rates and choke off home building. However, this seems unlikely until the second half of 2005 or 2006 at the earliest. When this happens, though, rates should not stay high long enough to effect the better home builders. However, a significant downturn in the near future that greatly reduces employment could have devastating effects in the overall economy and home builders in particular. This seems less likely as the recovery continues. Based on this outlook investors should have a minimum two-year horizon for investing in home builders.

Many of home building companies were not publicly traded during the last downturn in the housing market. Following many years of success, some management teams may not be up to the challenge of a down market. Indeed, during a down market we could see some of the better run firms acquire other firms.

Where is the Value?

Home builders are part of the Construction Services Industry. The five companies shown below represent over 25% of the market capitalization of the 125 U.S. companies in this industry. These companies have an integrated business model, and were picked based mainly on free cash flow, sales, and earnings per share. Profit margins and debt/equity ratios were also considered. These companies have a combined market capitalization of about \$19.4B. Using market

weighted averages they have impressive numbers for price/free cash flow (16.9), price/sales (.69), and price/earnings (9.3).

Comparison of Valuation Values (1/9/03)

	Market Cap (\$M)	Price / Cash Flow	Price / Sales	Price / Earnings	Profit Margin (%)	Debt / Equity
Centex Corporation	6,177	10.0	0.64	9.3	6.88	2.75
KB Home	2,580	12.0	0.48	7.6	6.34	1.13
Lennar Corporation	7,051	20.9	0.84	10.0	8.44	0.51
M.D.C. Holdings, Inc.	1,759	32.8	0.66	9.3	7.15	0.66
The Ryland Group, Inc.	1,802	16.5	0.60	8.8	6.76	0.74
Combined	19,369	16.9	0.69	9.3	7.39	1.34

Historical Valuation Ratios

For the selected companies the average current P/Es (9.3) are slightly above the midpoint between their five-year lows (4.9) and highs (12.9). However, for the entire industry the current P/E of 15.6 is near the five-year high of 16.5. This table also shows that profit margins are higher than five-year averages for all selected companies and the entire industry. This is due to a combination of improved business models and pricing power due to low mortgage rates.

Historical P/Es and Profit Margins

	P/E 5 Yr. Low	P/E 5 Yr. High	P/E Current	Profit Margin	5 Yr. Profit Margin
Centex Corporation	4.7	14.4	9.3	6.88	4.79
KB Home	4.2	12.2	7.6	6.34	4.80
Lennar Corporation	5.7	12.6	10.0	8.44	6.15
M.D.C. Holdings, Inc.	3.9	11.2	9.3	7.15	6.27
The Ryland Group, Inc.	4.1	11.8	8.8	6.76	4.12
Combined	4.9	12.9	9.3	7.39	4.80
Industry	5.2	16.5	15.6	6.04	4.54
S&P 500	16.2	48.2	26.4	12.68	11.20

Company Summaries

Centex Corporation (CTX)

Centex operates in five business segments: home building, financial services, construction products, construction services and investment real estate. This allows Centex to provide home buyers with financing, engage in other forms of real estate development, and provide construction materials to builders. The business segments operate in all regions of the United States. Even though Centex has a high debt/equity ratio, it was included based on its extraordinary cash flow.

KB Home (KBH)

KB Home focuses on first-time and first move-up homebuyers in medium-sized developments close to major metropolitan areas. It has a home mortgage subsidiary to provide financing. It has operations in Arizona, California, Colorado, Florida, Nevada, New Mexico and Texas as well as France. KB Home has grown by acquiring smaller home builders.

Lennar (LEN)

Lennar's two core businesses are home building and financial services. The financial services segment provides mortgage financing, title insurance, closing services, and insurance agency services. This allows the company to provide one-stop shopping for new home buyers as well as provide financial services to others. The company operates in Florida, Maryland, Virginia, New Jersey, North Carolina, South Carolina, Texas, Illinois, Minnesota, California, Colorado, Arizona and Nevada. Over the past few years it has grown by acquiring small companies in existing and new markets.

MDC. Holdings, Inc. (MDC)

MDC has two subsidiaries, Richmond American Homes and American Home Mortgages, which allows it to provide full service to its home buying customers. In the past MDC has operated in Colorado, Utah, Virginia, Maryland, California, Arizona, Nevada, and Texas. In the past year it acquired a home builder in Florida. Despite its relatively high price to free cash flow MDC was chosen because of its integrated business model and the strength of its other valuation metrics.

The Ryland Group, Inc. (RYL)

Ryland is a national home builder and financial services firm specializing in single family homes for the first-time buyers as well as retirees. Ryland has operations in Maryland, Illinois, Ohio, Indiana, Minnesota, Washington, D.C., Georgia, Texas, the Carolinas, Texas, Florida, California, Colorado Denver, and Arizona. It offers a variety of options and styles that are designed to be consistent with local preferences.

Create a Personal-ETF

Exchange traded funds (ETF's) offer an excellent low-cost way to participate in the broader market or major market segments or industries. Unfortunately, there is no available ETF that focuses on a small segment like home builders. However, by investing in these five home builders you can create your own Personal-ETF. Through a discount broker an investment similar to the one shown in the table below provides a low-cost way to invest in the industry. For an investment of about \$10,000 the transaction cost is only about .62%. This compares very favorably with mutual fund or ETF fees, and this cost would be cut in half with a \$20,000 investment. Since this is at least a two-year investment, the annual cost would be halved again.

Personal-ETF Components

Company	Shares	Price (\$) 1/13/04	Share Cost (\$)	Commission (\$)	Total Cost (\$)	Percent of Personal-ETF
Centex	20	98.81	1,976.20	12.95	1,989.15	19.03
KB Homes	30	65.96	1,978.80	12.95	1,991.75	19.05
Lennar	25	87.50	2,187.50	12.95	2,200.45	21.05
M.D.C. Holdings	35	59.48	2,081.80	12.95	2,094.75	20.04
Ryland	30	72.13	2,163.90	12.95	2,176.85	20.83
Total				64.75	10,452.95	
			Transaction Cost (%)	0.62%		

Cash is King

To reiterate: the ultimate reason for interest in home builders is the anticipation of a strong free cash flow that can ultimately be returned to shareholders in the form of dividends or share buybacks or used to increase the value of the firm through acquisition or internal growth. Some

home builders already pay a small dividend and repurchase shares in the open markets. With recent changes in dividend taxation law much of the underlying reason for share repurchase has been eliminated. What I would like to see is a company that is paying a dividend, doing little or no share repurchase, retiring debt, and making some capital investment.

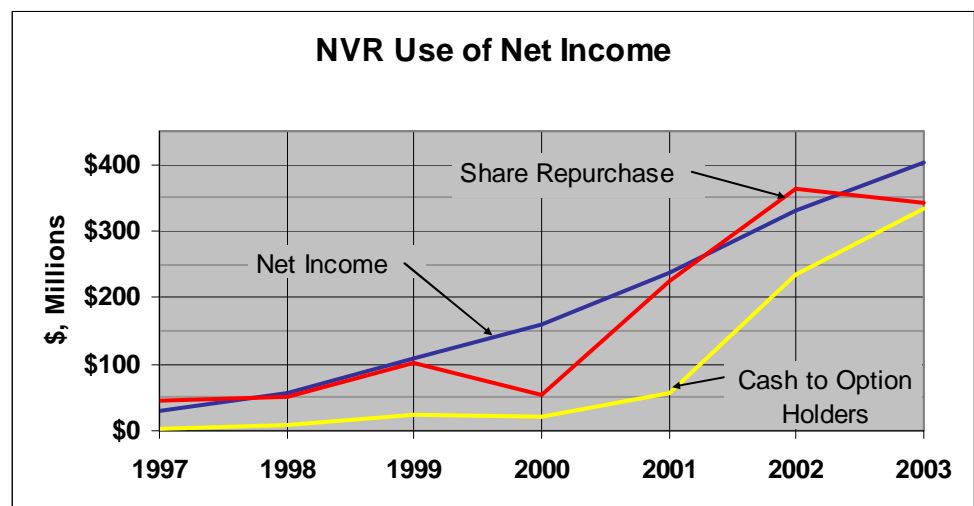
All of the values in the table below are millions of dollars for the first three quarters of 2003. Negative numbers represent issuance of debt or shares. Lennar and MDC stand out as stars in their use of cash from net income.

Net Income Flow to Shareholders

	Centex	KB Homes	Lennar	MDC Holdings	Ryland
Net Income (\$M)	328.9	232.0	468.2	145.2	155.5
Share Repurchase (\$M)	-14.6	86.7	-14.3	13.9	76.1
Debt Retirement (\$M)	-268.5	190.9	27.5	3.0	-37.4
Dividend (\$M)	4.9	8.9	3.0	8.1	1.5
Capital Expenditure (\$M)	21.5	0.0	13.8	4.6	24.6

One to Avoid

Initially NVR Inc. was included because of strong free cash flow and solid ratios. However, upon further investigation based on a Motley Fool article, this stock was removed. As shown by the Chart at right there is one very big flaw in the business model of home



builder, NVR. Historically, NVR has on average used 90 percent of net income (blue line) to repurchase its stock (red line). Insiders are now selling shares acquired through options (yellow line) at a level that nearly equals the stock repurchases by the company. In effect all of the cash flow to shareholders is diverted from long-term investors to this class of investors I think of as nano-shareholders because they hold their shares for about a nanosecond. With the large number of in-the-money options outstanding this process will continue. However, soon the company will no longer be able to reduce shares outstanding because more treasury stock will be reissued to cover option purchases than can be repurchased with net income. At best this is laboratory experiment in finance gone awry or a text book example of an agency problem.

Conclusions

In the long run these companies are creating a new asset class for people who could not previously afford to own real estate via home ownership. It seems reasonable to expect that the percentage of people who would like to own homes has not peaked at 67.9 percent. With

continued low mortgage rates and affordable housing available, the upward trend should continue. However, when the next downturn does come, the companies with the strong free cash flow will be able to maintain or even increase shareholder value. Even though the selected companies are near a midpoint of their historical valuation ratios, the industry is at the high-end. I like to purchase stocks when they are at low historical valuations, and recently the market seems determined to take home builders lower.

Home builders have enjoyed a great run, and that alone may be enough for many to conclude that it can't go on. Many will want to exit at this point in anticipation of the next downturn or to harvest profits. More than just NVR insiders have profits to take. This will put pressure on prices. This could result in just a little market turbulence, but I think there will be a major correction, now. This will provide a buying opportunity since a pullback of 20 – 30 percent will put these stocks in the lower quarter of their historical valuations. If this occurs and sales are still strong and conditions still favorable in the housing market, then consider buying. Although I think it is seldom wise to try to time the market, this is one time that it will not be good for the average investor to jump into the market during the selling that could go on for many weeks. During that time continue to look for opportunities elsewhere and wait to invest in home builders until they are a better value.

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