

## Rich at 10.9 times

Evan Lorenz writes:

A cohort of perky manufacturing stocks belies the persistent post-September weakness in industrial activity (United Rentals, Inc., featured in the prior issue of *Grant's*, springs to mind as an example). We write to untangle that paradox, to discuss the latest goings-on in residential real estate and to throw some analytical shade on Mueller Industries, Inc. (MLI on the New York Stock Exchange), America's largest maker of copper pipes and fittings.

Mueller, like many another industrial overachiever, is keyed to the construction market—happily so, for the time being, as building is on the rebound. The National Association of Home Builders/Wells Fargo Housing Market Index, which measures the degree of difficulty that developers confront in selling new homes, collapsed to 31 in December 2022 from 84 a year ago before recovering to 42 in February. The bounce is in sync with the 6.3% rally this year in the homebuilding component of the S&P 500, outpacing the overall blue-chip gauge by two percentage points. Whether it's in tune with the facts on the ground is another matter.

The housing market typically picks up after Christmas, Rick Palacios, Jr., head of research at John Burns Real Estate Consulting, reminds me: "That's not unexpected. Even in the worst years of housing, going back to the post-subprime collapse, you always get a little bit of a seasonal blip right around this time in terms of transaction volumes, because that's the time when people get back out into the market."

However, there was more than just

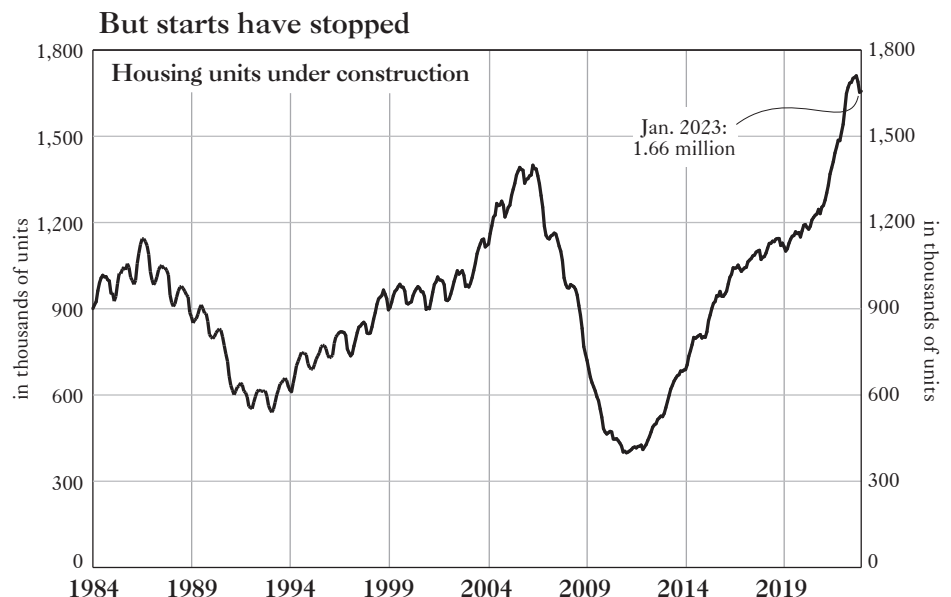
normal seasonality in the latest bounce: Builders are slashing prices on new homes and offering incentives like concessionary mortgage rates. "If you are a homebuilder and your footprint is Texas or anything west of Texas, I think new-home prices are probably down peak-to-trough a good 15%–20%," Palacios goes on. "It's a different story, though, if you are anywhere east of Texas, because the Southeast, the Northeast and the Midwest didn't really have as big a run-up this cycle."

The 45% spurt in home prices between December 2019 and June 2022 delivered a corresponding lift to the profitability of the builders of those structures. Lennar Corp., for example, enjoyed a bulge in adjusted gross mar-

gins on home sales to 26.8% in 2021 and 27.7% in 2022 from an average of 20.2% in the three years ended 2019. But the recent, inventory-clearing drop in prices has management projecting a decline in gross margins, to 21%, in 2023.

Suppliers will share the builders' pain, the builders promise. "Make no mistake: Lennar led the way with the reduction in margins while maintaining volume and increasing market share as the market has corrected," executive chairman Stuart Miller told listeners on the Dec. 15, 2022 earnings call. "We expect our trade partners to work side by side with us and follow suit."

In January, housing starts were running at the annual rate of 1.3 million, down 28% from the 1.8 million reg-



source: U.S. Census Bureau



source: The Bloomberg

istered as recently as last April. The decline in starts, combined with the easing of Covid-era supply constraints, has kicked the props out from under the price of lumber, which is off by 77% since its all-time high in May 2021. Because of this collapse, sawmills have shuttered. And because sawmills have shuttered, wood-pulp prices have climbed. And because wood-pulp prices have climbed, toilet paper has entered a new bull market.

There are knock-on effects, too, in the homebuilding business. For instance, even as housing starts stop, later-stage construction continues. According to the U.S. Census, developers were at work on 1.66 million single-family homes and apartments in January, only slightly below the record high of 1.71 million set in October 2022 and compared with an average of 1.1 million in-progress units in the three years ended 2019. Pending a revival in starts, of course, later-stage construction activity will eventually stop cold.

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Mueller Industries was founded by namesake Oscar Mueller in 1917 in Port Huron, Mich. as an ammunition maker to support the U.S. war effort. Oscar came from an entrepreneurial German immigrant family. His father, Hieronymus, founded what would later become Mueller Water Products, Inc., a maker of fire hydrants, valves and other water-infra-

structure products, in 1857. After 1918, Oscar's company pivoted to manufacturing copper and brass gears, bearings, pipes, valves and other devices for the plumbing and refrigeration industries.

Today, Mueller is the largest maker of copper tubes and pipes in the United States, ahead of closely held Cerro Flow Products, LLC. Mueller's product offerings include copper and cross-linked polyethylene (PEX) piping as well as fittings, line sets, pipe nipples and related products; valves, protection devices, brass fittings and twisted copper tubes for refrigeration and air conditioning; metal rods, shapes, valves and machined metal products.

Three-quarters of Mueller's sales originate from within the 50 states. End markets include commercial

construction (46% of trailing sales), residential construction (44%) and remodels (10%), though home sales weigh more heavily than the list implies. Not a few of the commercial construction applications of Mueller's products, e.g., schools, retail strip malls and hospitals, owe their impetus to residential building.

You'll never mistake extruding a copper tube with fabricating a cutting-edge microchip. "These are age-old industrial processes," Mueller CEO Gregory Christopher told the Sept. 22, 2022 Sidoti Fall Small-Cap Virtual Conference. And a good thing it is, too, in one respect: As alternative materials have taken share from copper, Christopher added, "the scope of competition across the world has greatly shrunk." So it happens that Mueller finds itself "the only producer in Canada," the only producer in the U.K. and the only producer throughout the Middle East.

Washington, D.C. deserves a thank you for this enviable lack of competition. In 2010, the government imposed anti-dumping duties on copper pipe exported from China. And when, in response, Chinese producers picked up and moved to Vietnam, the United States slapped anti-dumping tariffs on pipe from Vietnam, too.

Post-Covid lockdowns and the stimmie-enhanced construction boom worked wonders. Mueller benefited from the increase in commodity prices, as copper surged by 76.5% to \$4.94 per pound on March 4, 2022, from \$2.80 at year-end 2019, before settling at \$4.22 today. As management typically structures its contracts to earn a spread above copper prices, revenue billowed. Gross margins leapt to 28% last year from 16%

**Mueller at a glance**  
all figures in \$ millions except per share data

	2022	2021	2020	2019	2018
revenue	\$3,982.5	\$3,769.3	\$2,398.0	\$2,430.6	\$2,507.9
operating profit	877.1	655.8	245.8	191.4	173.0
net income	658.3	468.5	139.5	101.0	104.5
earnings per share	11.64	8.25	2.47	1.79	1.82
shares outstanding	56.6	56.8	56.4	56.3	57.3
cash	678.9	87.9	119.1	97.9	72.6
debt	2.0	1.9	327.9	386.3	496.7
total assets	2,242.4	1,728.9	1,528.6	1,370.9	1,369.5

source: company reports

in 2019 as earnings per share shot to \$11.64 in 2022 from \$1.79 in 2019.

"Mueller is not out of the norm," notes Ryan Connors, who rates MLI a buy for Northcoast Research Partners, LLC. Connors says he's seen "anywhere from a tripling to a quintupling of earnings for [his] coverage [which includes such industrial companies as Watts Water Technologies, Inc.] in the past two-and-a-half years." To date, building contractors are not pushing back on Mueller's price hikes, Connors tells me. "They're just sort of accepting it now. The question of 'where earnings will normalize' is largely a function of how successful the Fed is in squashing those inflation expectations out of the economy." Connors says he expects that Mueller's gross margin will come to rest at 22% of sales, or a cool six percentage points above the 2019 level.

Management has applied its earnings gusher to paying down debt and returning cash to shareholders. At year-end 2019, the balance sheet showed a net debt balance of \$288.3 million; as of Dec. 31, 2022, a net cash balance of \$676.9 million (or \$11.97 per share compared with a current share price of \$71.53). Last year, the shareholders received \$1 per share in dividends (for a dividend yield of 1.4%), compared with \$0.40 in 2019. In 2022, Mueller repurchased \$38.1 million's worth of stock versus an average of \$4.1 million in the prior three years.

While Christopher has been a good allocator of capital, he does not love the limelight. Mueller holds no conference calls following earnings releases and rarely participates in investment-bank conferences. My calls and emails to the Mueller investor-relations department went unreturned. So the would-be analyst of Mueller's business and financial position must mine the 10-Q or 10-K reports on file with the Securities and Exchange Commission.

Only two sets of analytical eyes are fixed on MLI, and each rates the shares a buy. (On average, companies that command market caps of between \$4 billion and \$5 billion attract 10 analysts.) Only one of the two—that would be Connors at Northcoast—publishes numbers that earnings-estimate aggregators like Bloomberg track. He sees

EPS falling 43% year over year in 2023 to \$6.58 per share, which values Mueller at 10.9 times forward earnings.

Bears have been building positions in MLI, pushing short interest to 7% of the float from 1% on Jan. 14, 2022. Mueller executives seem sympathetic to that point of view—they sold 67,159 shares over the past year, for proceeds of \$4.9 million. They bought plenty in 2018, though, when the price dipped below \$30, less than half of today's \$71.53.

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Installing the types of pipes that Mueller manufactures is typically an intermediate construction step, taking place before the addition of finishing touches like cabinets and appliances but after the completion of final framing and roofs. This means that Mueller's residential sales are keyed off the near-record number of housing units still under construction. As builders work through that backlog, Mueller will feel the pinch.

Builder KB Home is proud to have lowered its cost of construction by \$10,000 per house between its third and fourth quarters last year. "That's not just lumber," Chief Operating Officer Robert McGibney crowed to dialers-in to the Jan. 11 earnings call, "but I would say we're still in the early innings of cost-reduction efforts. We're getting more traction on the front-end trades where those trade partners are feeling the impact of lower starts across our markets....I'd say [we're in] the early innings of the cost-reduction work that we're doing on the front end. It's really just getting started on the back end as a lot of those trades haven't felt it yet."

KB Home isn't just negotiating lower prices, McGibney continued. "We have a lot of initiatives in play right now through value engineering, simplification, lowering our spec levels [and] adjusting elevations to drive cost out."

While copper tubes play an indispensable role in air conditioning and refrigeration, they are slowly losing market share to PEX piping in gas and water applications. An Oct. 18, 2020 article on BobVila.com explains the upsides and downsides of both mate-

rials. In copper's favor: It lasts longer than PEX (50–70 years versus 30–50). In plastic's favor: PEX is cheaper (HomeDepot.com lists Mueller's one-inch copper pipe at \$5.43 per foot versus \$0.90 per foot for a PEX pipe of the same diameter). And because PEX is more flexible, it requires fewer connecting joints (making it cheaper and easier to install). It's also less likely to burst in a sudden freeze.

It ought not to embolden the bulls that copper tubes account for roughly two-thirds of Mueller's revenues, according to Connors's estimates. While volumes did jump by 6.4% in 2021, reversing a 7.9% cumulative decline in the five years ended 2019, they slumped by 5.3% in the first nine months of 2022.

Besides, the cozy American copper tubing market is about to become a little less cozy. Zhejiang Hailiang Co. Ltd., the Chinese copper rods and tubes target of the 2010 and 2021 U.S. anti-dumping action, is building a copper-pipe factory in Sealy, Tex., which offers relatively cheap land, low property taxes and no anti-dumping drama. Production is slated to start in the first half of this year. If all goes according to plan, Hailiang will ramp up production in three stages, with each stage representing approximately 10% of North American copper-tube capacity.

While Mueller does not look especially expensive at 10.9 times the 2023 estimate, the guess for this year's earnings is 268% above the 2019 level—quite a stretch given the looming contraction in core construction markets, increased competition and the homebuilders' cost-cutting drive.

In the three years ended 2019, MLI traded at an average of 18.4 times trailing earnings. Multiplying that 18.4 multiple by 2019 EPS of \$1.79 yields a per-share value of \$32.94. Adding the \$11.97 in cash per share on the balance sheet to that sum would value Mueller at \$44.90, or 37% below the current share price. Of course, injecting 30% capacity to a cyclically slowing market with increasingly price-conscious buyers could mean that the 2019 earnings figure is a ceiling, rather than a floor, to future profitability.

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