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Raising the roof

"Existing" home sales for May fell by 1%, the 15th consecutive monthly decline (non-existing home sales go unreported), while June housing permits dropped by 7%. Even so, a hopeful look at the housing situation and a bullish analysis of Lennar Corp. (LEN on the New York Stock Exchange), America's largest homebuilder by sales, is the business at hand.

Admittedly, the macroeconomic narrative isn't all it might be. Apart from those forbidding statistics, the yield curve is inverted, industrial production is sputtering and construction is waning in this, month 121 of the longest economic expansion in American cyclical history. And if that weren't enough, homebuilders simultaneously confront slow sales and rising costs. It's well and good that lumber prices, which represent 13% of the direct costs of building a house, have decreased by 37% in the past year, but wages, which represent 43% of those costs, have climbed by 7.7%.

As for mortgage rates, the post-November plunge—to 3.8% from 4.8% on a 30-year, fixed-rate, Fannie-and-Freddie-conforming loan—is certainly helpful, as far as it goes. But the appointment of the no-nonsense Mark Calabria as director of the Federal Housing Finance Agency promises tighter federal mortgage-underwriting standards ahead.

The bullish case begins with the observation that the frightening events of 2007–09 continue to haunt the market. From peak to trough, housing starts declined by 79%, house prices by 35%. You would have thought it impossible—indeed, most economists believed exactly that.

In the 6½ years ended March 31, 2015, outstanding mortgage debt shrank by 10.7%. This, too, was an apparent impossibility, as there had never been a year-over-year downtick in mortgage outstandings between 1945 and 2007. While the stock of mortgage borrowing is once again growing, the $10.4 trillion outstanding today nonetheless remains below the peak of $10.7 trillion set in the first quarter of 2008 (though from then till now, the consumer price index rose by 19%).

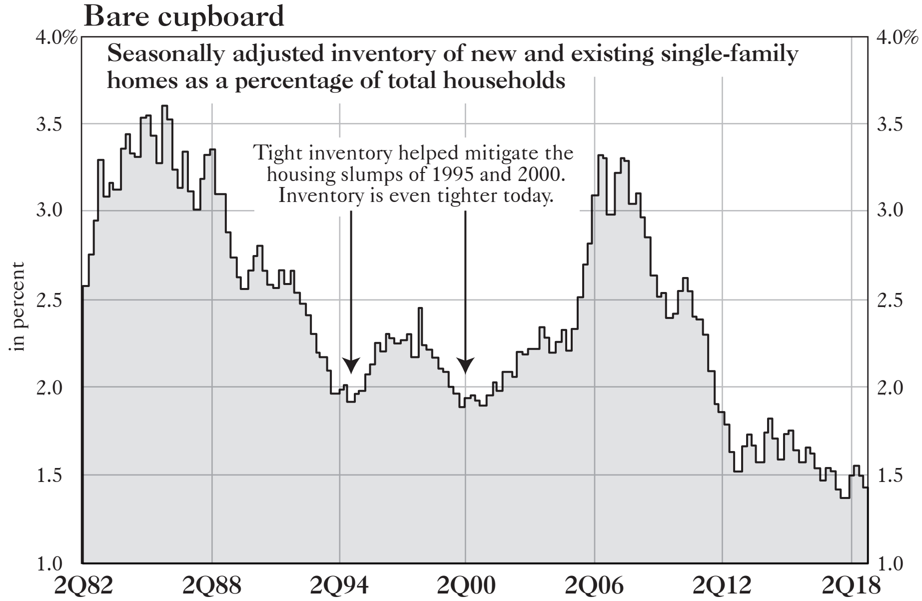
But past is likely not prologue. Bloated household borrowings, which number among the top contributing causes of the crackup, are blessedly absent today (business debt is the new looming danger). From the start of the downturn in the fourth quarter of 2007 to the first quarter of 2019, household debt as a percentage of GDP contracted to 75% from 97%.

Housing is not so cyclical in the absence of a Main Street debt crisis. Thus, in the real-estate-cum-junk-bond slump of 1990–91, new home sales fell by 6.5%; in the dot-com break of 2001, they slipped by 1.6%.

A repeat of the 35% peak-to-trough collapse in house prices in 2006–12 is, of course, not impossible, but it's hardly likely. "There is now this massive pool of capital, institutional capital, ready and waiting on the sidelines to scoop up any inventory [of single family homes] they can possibly get their hands on," Rick Palacios, Jr., the director of research at John Burns Real Estate Consulting, tells colleague Evan Lorenz.

Then, too, while the overall economic expansion may be old, the housing re-

Bare cupboard



source: Zelman & Associates

covery is young. Though business activity bottomed in June 2009, house prices didn't stop their descent until June 2012. Building was even slower off the cyclical mark.

After slowing to a 478,000 annualized pace in April 2009 from a peak of 2.3 million in January 2006, housing starts broke above 1 million for the first time in November 2013. For context, 1.4 million is the annual average over the past five decades.

"We are focused on the volume of heavy supply, and, in those terms, as opposed to price, we are only in the third or fourth inning of a recovery," Marvin Shapiro, the CEO of Avanti Properties Group, which buys raw land to develop into lots for builders, tells Lorenz. "There is significant running room ahead."

Nor is overhead supply a worry. The number of homes on the market today amounts to less than 1.5% of American households, a historically low figure and, of course, a bullish one. It's the direct result of (1) the millennial-in-the-basement phenomenon of the immediate post-crisis years and (2) a persistent dearth of construction.

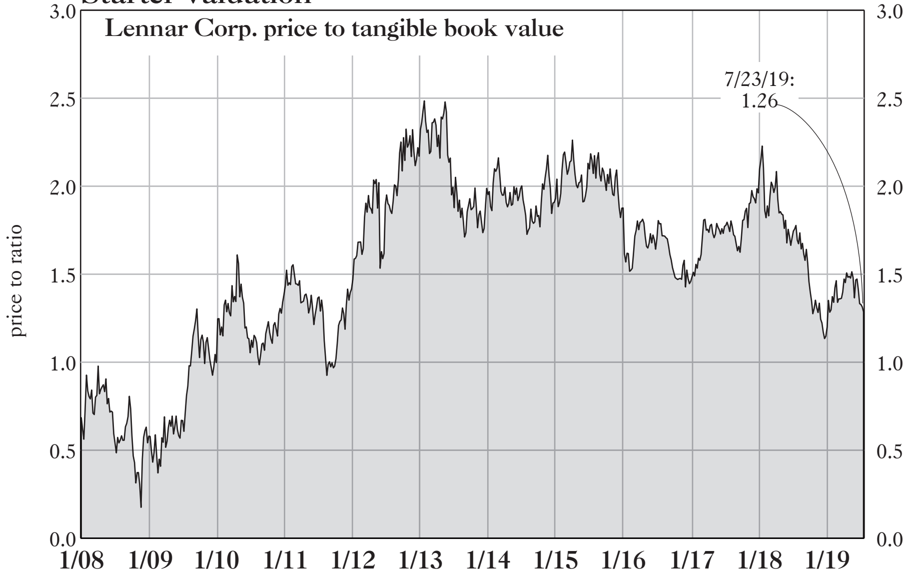
From June 2009 through March 2019, 8.6 million housing units rose from the ground. Over the same period, the number of American households expanded by 10.2 million to 122 million. Freddie Mac estimates that, as of mid-2018, this country was short 2.5 million houses.

If "underbuilding" is one buzzword of the cycle, "shared households" is another. In the seven years from 2007 to 2013, according to Josh Steiner, housing analyst at Hedgeye Risk Management, "you went from 19.7 million shared households to 23.2 million." Bulls may think of those house-sharing young folk as tomorrow's home buyers.

Homebuilders bear some of the blame for the clear mismatch between supply and demand. From 2001 through 2007, 31% of houses completed were less than 1,800 square feet, a proxy for the designator "affordable," and only 22% were more than 4,000 square feet. Since 2011, 29% of all new constructions have measured greater than 4,000 square feet while only 24% of homes have qualified as affordable. Demand for high-end houses has been amply met. Not so demand from first-time buyers and first-time move-ups.

What we have here, says Ivy Zelman, CEO and eponym of Zelman & Associates, is a tale of two markets: "If you

Starter valuation



source: The Bloomberg

were a builder operating exclusively at the entry-level and first-time move-up segments, you would probably say the spring was an 8 or 9 on a zero-to-10 scale. However, if you are a builder in the second-time move-up and luxury price points, you are probably more like a 5 or 6." As most builders span the range of affordable and luxury, the first half of the year has been a muddle.

But the builders are catching on. "In communities where we own land that can serve entry-level housing, we can't keep the finished lots on the shelves," says Avanti Properties Group's latest client advisory. "And in our new investments, we have builders expressing serious interest in buying from us even before we close."

"There's a demographic wind at the back of the market, too," Lorenz relates. "In America, there are 4.4 million people who are 32 and 4.4 million who are 33—and it happens that the peak age for first-time buyers is 33. And behind these cohorts are the 9.6 million prospective buyers age 28 and 29."

Certainly, buying has rarely held a keener edge over renting than it does right now. At cyclical ebbs, the ratio of average mortgage payments to average rental payments registers near one; at cyclical peaks, it stands at two. Today the figure is "around 0.95," says Steiner. "So, believe it or not, the national median mortgage payment is less than the national median rental payment right now." As for Calabria, even if he does tighten underwriting guidelines for Fannie and Freddie, the Federal Housing Administration offers mortgages with a down payment of as little as 3%.

And because appearances count, too, easy comparisons with the second half of 2018 (when mortgage rates were higher and home sales and equities much lower) mean that homebuilders will likely report second-half figures that are not only substantively pleasing but also optically so.

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Lennar, the largest and one of the cheapest homebuilders, got its start in 1954 in Miami. Executive Chairman Stuart Miller, son of co-founder Leonard Miller, controls the company through super-voting stock. The B shares carry 10 votes each, but the A shares, with only one vote, have the edge in liquidity.

Lennar, which is active in 19 states, delivered 48,316 houses and generated $21.6 billion in sales in the 12 months ended May 31. It operates a single main division, homebuilding, which accounts for 92% of trailing operating income, with two add-ons: mortgages and insurance (7%) and multifamily (1%). You can see the beginnings of a shift to the affordable end of the market in the reduction of the average Lennar sales price, to $408,000 in the six months ended May 31 from $413,000 in the same period last year.

"Between 2007 and 2009," as Lorenz observes, "Lennar only distinguished itself by surviving, but the $3.5 billion of cumulative losses did focus management's mind." Post-crisis, the company has worked to shed assets and improve risk control. Thus, as of May 31, 26% of Lennar's 215,000 lots were held by option rather than outright purchase. If all goes according to plan, that 26% will become 40% before 18 months are up. "We love this new business model as it will generate high [internal rates of return], strong margins, leverage our existing overhead with no accompanying land risk," CEO Rick Beckwitt said on the June 25 earnings call.

The February 2018 acquisition of homebuilder CalAtlantic Group, Inc., for $9.3 billion in stock, presents Lennar with another hurdle to clear. As a percentage of capitalization for Lennar's homebuilding segment, debt today stands at 38%, up from 34% before the acquisition and down from 45% when the deal closed. Management says it means to lower that figure to 30%. Successful integration of CalAtlantic could improve operating margins, and the transition to a more options-based land strategy should lower capital intensity. Improved returns on invested capital would be the marker of success.

Classified under the heading, "The potential for a little something extra," is the $800 million invested in a pair of Lennar-managed multi-family venture funds. By the end of next year, speculates J.P. Morgan Securities analyst Michael Rehaut, the assets from the first fund will be ripe for monetization in one form or another.

"Through the 12 months ended May 31," Lorenz notes, "Lennar generated $1.1 billion in free cash flow, a material figure relative to the $14.4 billion Lennar market cap. Such cash generation bodes well for debt redemption and stock repurchases—in the second quarter, management spent $52 million to buy back 1 million shares. Free cash flow is also somewhat countercyclical: In a downturn, Lennar can choose to buy less land, thus boosting cash. Between 2006 and 2008, Lennar's free cash flow doubled to $1.1 billion from $527.9 million."

The shares are priced at 1.26 times tangible book and 8.6 times estimated fiscal 2019 earnings (Nov. 30 is year-end). For comparison, D.R. Horton, Inc. and PulteGroup, Inc. change hands at 1.77 and 1.7 times tangible book at 11.2 and 9 times the 2019 earnings estimates; NVR, Inc., the class of the industry, trades at 6 times tangible book and 16.8 times the 2019 estimate (*Grant's*, April 19).

"Investors are dubious about builders given nearly every public lost a ton of money and wrote off over 50% of their equity during the Great Recession," Zelman tells Lorenz. "Furthermore, when it comes to early cyclicals, most investors don't want anything to do with homebuilders given the late stage of this economic recovery. That's really why the sentiment is so negative. Not to mention the macro data has remained ugly. Housing starts, new-home sales and existing-home sales have all been down year-over-year. Furthermore, public data has reported that home-price appreciation is decelerating."

Single-family starts are the best government data point, Zelman continues, but "what investors are missing is that starts are not reflective of the market health, given that builders are not starting new inventory as they work through the speculative inventory they got caught with in late 2018 as demand slowed. During the first half of this calendar year, builders have been selling through that inventory successfully given a strong rebound in demand as rates have plummeted. For five out of the last six months of 2019, our proprietary survey results reported stronger than normal seasonal order results. For June, our survey contacts' orders, which are indicative of demand, were up 11% year-over-year following 4% growth in May and a 2% increase in April. Orders were down more than 20% as recently as December 2018, so that is a remarkable turnaround. The market doesn't see it because they are dependent on government data, which are lagging, and not reflective of the underlying strength we are reporting. The market is waiting for some good news, which we believe is around the corner."

"While the market waits," Lorenz sums up, "note that the last time that Lennar traded at such a low multiple of tangible book was in 2011, a year when house prices were still falling. And the company's low price-earnings ratio is not because the Street is penciling in peak earnings—analysts estimate the earnings per share will shrink by 16% year-over-year in 2019. 'It is basically at 11% of its trailing five-year range on price to tangible book,' Steiner tells me. 'There are only a few companies that are that cheap or cheaper, but, for the most part, especially for a large cap, it is much, much cheaper than just about everything else out there.' Zelman, whose firm has received compensation from Lennar for non-investment-banking services, says Lennar is her top pick among large-cap stocks."

Of the 18 analysts who cover Lennar, 16 say buy and none says sell. Over the last 12 months, only one insider, President Jonathan Jaffe, has sold shares—80,000 for net proceeds of $3.7 million. The information content of those dispositions is unclear. Rain or shine, faithfully once a quarter, Jaffe sells a 20,000-share block.

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