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Up off the floor

Evan Lorenz writes:

Rising prices on falling volumes is a situation to set a stock jockey's teeth on edge. However, even after surveying house prices (up), real estate transaction volumes (down) and mortgage rates (up and up), we end this analysis on an upbeat note: bullish, still, on Mohawk Industries, Inc. (MHK) and bearish no more on Trex Co., Inc. (TREX; both on the New York Stock Exchange).

House prices, measured year over year, surged by 19.8% in February, according to S&P CoreLogic Case-Shiller. This was a slight decline from the 20% print of last August but higher than the 14.5% gain registered in September 2005, near the finale of that other housing blowout.

In March, according to the National Association of Realtors, "existing" home sales fell by 4.5%, to an annualized rate of 5.77 million, while listed inventories dropped by 9.5%, to 950,000 (again, calculated year over year). Nevertheless, inventories stood at two months' worth of sales, up from the all-time low of 1.6 months in January (in better-balanced markets, four to six months is the norm).

Meanwhile, construction booms. Last month, builders began work on an annualized 1.8 million dwellings, a 3.9% gain from a year ago and the fastest pace of starts since June 2006. According to the Census Bureau, there were 1.622 million single-family houses and apartments under construction, the most since February 1973. In mid-April, the average house on the market sold in just 17 days, according to real estate broker Redfin Corp., down from 24 days a year ago.

But here come interest rates. Thirty-day locks on mortgage rates were burning a hole in the pockets of home buyers in March. As borrowing costs leapt, that locked-in rate became a very valuable option, and house hunters who could exercise it punctually did so.

Christopher Whalen, publisher of *The Institutional Risk Analyst*, tells me that, owing to interest rate volatility, "the whole market is pricing off of spot. We are not doing any 30-day rate locks any more. It changes behavior. You are approved for the loan, but you don't know what the price is. For homeowners who are close to the edge in terms of being able to afford the loan, the variability in rates can be significant."

If buyers are rushing to contract, builders are slow-walking their marketing plans; surging commodity prices and snarled supply chains lend a new element of volatility to house prices, too. So prospective buyers go on wait lists, much to the benefit of the builders' operating margins, which (in the case of the S&P's roster of home builders) fattened to 14.6% last year from 10.2% in 2019. The risk is that a greater volume of unsold, in-progress inventory could depreciate come the next cyclical downturn.

"Right now, cancellation rates haven't moved significantly higher on a percentage basis, and the reason is a [significant] well of qualified potential buyers," Rick Palacios, Jr., the director of research at John Burns Real Estate Consulting, told listeners to the April 7 *Housing News* podcast. "So, the builder is able to take the home and flip it. . . . So, it doesn't necessarily translate into a spike in cancellation rates, but that well of potential buyers starts to thin out. The qualitative commentary we got in our survey this month [was] builder after builder after builder telling us that our waitlists are shrinking."

Some shoppers are losing hope. In the

Mohawk Industries, Inc. at a glance
all figures in $ millions except per share data

	2021	2020	2019	2018	2017
revenue	$11,200.6	$9,552.2	$9,970.7	$9,983.6	$9,941.3
operating income	1,335.0	636.0	827.2	1,095.3	1,354.2
net income	1,033.2	515.6	744.6	861.7	971.6
earnings per share	15.01	7.22	10.30	11.47	12.98
shares	68.9	71.4	72.3	74.8	74.8
cash	591.9	1,340.4	177.3	119.1	84.9
debt	2,324.8	2,734.1	2,569.9	3,258.0	2,763.6
total assets	14,244.5	14,317.8	13,386.7	13,099.1	12,094.9

source: company reports

Suffered enough?

source: The Bloomberg

Federal Reserve Bank of New York's latest survey of homeowners and renters, just 43.3% of renters polled said they expect to own a home at some point in their life, down from 51.6% last year and the first reading below 50% since polling started in 2014. (For reference, since February, the 30-year mortgage rate has zipped to 5.42% from 3.77%.)

That the millennial cohort is entering its nesting years is one of the housing bulls' fundamental precepts. The downshift in construction that followed the mid-oughts slump left the country short of up to 3.8 million homes, Freddie Mac estimated last summer. Hence the relentless bid for shelter.

Of course, the price of a house counts, too. "Joey and Chandler are living together, and if apartments are cheap and their jobs are doing well, maybe they will both get individual apartments," says Bill McBride, author of the finance blog Calculated Risk, by way of reference to the hit TV show "Friends." "Now you've doubled the demand for apartments. But, if apartments are really expensive and their jobs aren't doing as well, they might move back together. It's not just roommates.

"A lot of that is price-driven," McBride goes on. "We've seen rents go sky-high and house prices go way up. If someone says, 'We are undersupplied by 5 million houses,' I don't know, I think it is a hard thing to put a number on it. If housing was half the cost it is today, we would need a lot more housing because a lot of immigrant families double up—two generations in the same house—and they would split up if things were a lot less expensive."

In the longer term, demographics feature into the bear case as well. "The U.S. is at its lowest population growth in history at 0.2%," Chris Hamilton, the author of the economics blog Econimica, points out. "In the 1970s we were 2% and then 1% a decade ago. That is your organic growth level. . . . Now you are taking it away."

Another mark on the negative side of the ledger is that, because three-fifth of mortgagees are paying 3.9% or less, selling one house to buy another may cause a rate shock. At 3.27%, the monthly cost to service a $350,000 mortgage is $1,527; at 5.42%, the nut jumps by 29%, to $1,970.

People gasped when the Volcker-led Fed pushed the funds rate to 20% in 1980, but a mortgage in that era could be passed down from seller to buyer, like an heirloom. "I bought a house in 1979 with an 11% mortgage rate," McBride tells me. "When I sold it in 1981 because I was moving for a job, it was a selling point that I had an 11% loan that could be assumed. Today, none of these 3% loans can get assumed. That's history."

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Barring a meaningful drop in borrowing costs, mortgagees are likely to remain in their homes for longer, leading to fewer transactions. Or so hopes the home-refurbishment trade. Stuck in place, an owner is more likely to invest in fixing that place up.

Which returns us to Mohawk Industries, America's biggest floor maker by sales, whose share price is down a cool 30.1% since a bullish appraisal featured in the Dec. 10, 2021 issue of *Grant's*. We continue to like many things about Mohawk, not least the absence of a pandemic stampede to pull forward the demand for its carpets, ceramic tiles, luxury vinyl tiles (LVT) and laminate and wood flooring. In the two years ended 2021, Mohawk's top line compounded at a 6% rate, of which half derived from price increases.

Two facts begin to explain this anemic growth. One, flooring typically requires professional installation; who wanted that kind of human contact during the pandemic? Two, commercial customers account for 34% of U.S. flooring sales. As workers decamped from offices and stores shuttered, businesses decided that new floors could wait. In 2021, Mohawk sold $11.2 billion's worth of flooring worldwide. The United States (55.2% of sales) is the company's single biggest market, followed by Europe (27.8%) and other foreign parts (17%).

If Mohawk could blame Covid-19 for what ails it, the stock would not be trading at 8.4 times net income. The underlying problem is rather that Big Carpet did not notice the U.S. shift to luxury vinyl tile that began in 2015. Then, having missed its market, management overinvested in new domestic ceramic-tile plants in 2017 and 2018. Too much of the wrong type of capacity (ceramic is a different product category than LVT, though each has "tile" in its name) sent operating profit down 38.9% between 2017 and 2019.

Last year, Russia delivered four percentage points of the afore-quoted 17% of sales sourced neither in America nor Europe. And because the international flooring unit is more profitable than the domestic one, 6% of operating earnings vanished with the invasion of Ukraine.

The post-invasion spurt in energy costs is broadly pressuring Mohawk's ceramic division. In the Feb. 10 earnings release, management said it expected a $40 million to $45 million headwind in the first quarter as those costs run ahead of price increases.

Scopia Capital Management, L.P.,

the hedge fund that actually hedges (*Grant's*, Nov. 26, 2021), counts Mohawk as a top position. With that understood, Greg Slavin, head of industrials research at Scopia, tells me that home-refurbishment outlays are cyclically resilient. Especially resilient, says Slavin, is spending on the kind of refurbishments that require professional installation—flooring, for instance. "The pros have a backlog of work," Slavin says. "These categories generally didn't over-earn in 2020 and 2021 because the pros had a limit to how much work they could do."

They are already doing more. The Architectural Billings Index rose to 58 in March from 51.3 in February (scores above 50 mean growth in billings). The index typically leads commercial real estate investment by 9 to 12 months. "Firms reported that at the end of the first quarter of 2022, their firm's backlogs stood at an average of 7.2 months," notes the accompanying press release. "This was an increase of more than a month from one year ago and a new all-time high since we began collecting data on backlogs in 2010."

One thinks twice nowadays before using the word "transitory," but the surge in energy costs in Europe is likely not for all time. Even so, says Slavin, the spike will knock $2 off of his prior $17 EPS estimate this year.

Ukraine was a key supplier for the raw materials to produce ceramic tiles in Europe, and a large number of European competitors, though not yet Mohawk, have had to shut their kilns. As the United States sources two-thirds of its tiles from abroad, Mohawk is the beneficiary of a pricing umbrella for its domestic tile production. After initially missing the consumer switch to luxury vinyl tile, Mohawk has rushed to catch up, and its new, waterproof laminate products are said to be gaining market share.

Over the next three years, says Slavin, "this is the best opportunity I see right now. I think I have a 40% IRR [internal rate of return] owning this stock today. My average opportunity is 8%. An 8% IRR is pretty standard. That is the earnings growth of most companies. This one is 40% because I think earnings can grow from $15 to $25 over the next three years."

Over the past decade, Mohawk has traded at an average of 15 times earnings, which Slavin sees as a fair multiple once Mohawk gets through a messy 2022. "You can have the combination of earnings growth, upwards revisions and a higher, more normalized multiple," he says.

Mohawk is an investment-grade credit (barely, at triple-B-plus), and its balance sheet is moderately leveraged. As of Dec. 31, net debt summed to $1.7 billion, or 0.9 times trailing Ebitda, and operating income covered interest expenses by 23.3 times in 2021.

Toward Mohawk, the Street registers 4 buys, 10 holds and 3 sells; short interest stands at 4.5% of the float. Year to date, insiders have purchased a net 9,494 shares at a cost of $1.3 million. Notably, Mohawk's chief operating officer and director, W. Christopher Wellborn, bought 10,000 shares at an average price of $135.76 on Feb. 24, the day that Russia invaded Ukraine (a small premium to the current price of $129.70). This was Wellborn's first purchase since November 2008.

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On, now, to Trex, a maker of residential decks, rails and fences fashioned from green and durable reclaimed wood, sawdust and plastic. Created in 1992 as a division of Mobil Oil Corp., one half of its predecessor, Exxon Mobil Corp., Trex left the clutches of Big Oil via a management buyout four years later.

The pandemic did Trex a good turn—indeed, almost too good a turn. For a stimmy-size price of $10,000 or less, one could install a deck on which to sit, perhaps sans mask, breathing fresh air, and one could install it oneself. Sales growth, in 2020 and 2021, shot to 26.7%, double the average rate of the prior five years. It was this clear evidence of future demand being pulled into the present that (among other things) led us to take a bearish view of the shares in the issue of *Grant's* dated Feb. 4.

Trex will not report first-quarter results until May 9, but management flagged a slowdown on the Feb. 28 earnings call. CFO Dennis Schemm informed listeners that the company had benefited from $100 million's worth of channel stocking in the second half of 2021 and that this was unlikely to happen again in 2022. (Full-year sales in 2021 came in at $1.2 billion.)

It's not easy to reconcile the guidance from the fourth-quarter press release with comments management made during that call. The front office said it expected revenues to grow by 32% in the first quarter and at a "double digit" for the full year. Schemm added that quarterly sales were likely to follow the seasonal patterns exhibited in 2016–18 and not the hyper-growth periods of 2020 and 2021.

In the three years ended 2018, first-quarter revenues averaged 26% of the 12-month total. The midpoint of first-quarter guidance was $325 million, which, if pre-Covid quarterly seasonality prevails, would imply full-year revenues of $1.25 billion, or a 4.3% year-over-year increase and well below the full-year guidance for a double-digit rise.

On the February call, analysts unsuccessfully prodded management to square the circle. "Look," snipped CEO Bryan Fairbanks, "we've provided guidance of a double-digit revenue improvement during the course of the year." Count us—and not a few others, we have no doubt—mystified.

Since we had our say on Trex on Feb. 4, the shares have sunk by 35.6%, slightly edging Mohawk on the downside. While hardly cheap at 27 times trailing earnings and 20.8 times enterprise value to trailing Ebitda, prevailing multiples are in line with the deck maker's average valuation in the five years before Covid struck.

We wouldn't buy it, and we wouldn't rule out a cheaper valuation if the big S&P arrow continues to point down. However, at the current price, the multiple no longer reflects the pandemic growth bump, and we wouldn't sell it short, either.

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