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Steven McIntyre and Todd Stein, CFA

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HOMEBUILDERS: WHERE IS THE FREE CASH FLOW?

*“Real estate speculators are buying at a pace that far exceeds previous estimates of their influence on the housing market, according to a first-of-its kind report released Tuesday by the National Association of Realtors. **Collectively, investors and second-home buyers bought more than one of every three homes sold in last year’s record market**... ‘I am astonished,’ said David Lereah, the association’s chief economist, who said that the data suggest a sea change in the role of real estate in the nation’s economy. ‘What we’re seeing is that real estate is no longer just a place to live. It’s a viable alternative to stocks and bonds,’ Lereah said. ‘Sept. 11 changed real estate forever, the way people look at it. They’re nervous about stocks and bonds and they’re placing money in real estate, which has proven to be a stable and wealth-building asset.’” **Chicago Tribune, March 2nd***

It now appears fairly clear to us that the U.S. residential housing bubble is reaching its parabolic terminal stages. Witness the near maniacal run-up in California and other high end real estate at 20% clips on top of already huge runs, the staggering revelation that some 1/3 of homes are now being bought for investment (speculative) purposes, and the latest surge in homebuilder stocks despite ominous storm clouds. The fact that the data being spewed from an industry trade groups like the National Association of Realtors reveals so much speculative buying makes us wonder if the true numbers aren’t even more troublesome. Even Merrill Lynch (who got out of the commodities business right before the bottom) is launching an expensive ad blitz to push “Total Merrill”. “Total Merrill” touts a financial services giant that can solve all of an individual’s needs. The new wrinkle in the pitch principally being that Merrill is not just your place for stocks and bonds, but also for real estate and mortgage management. Real Estate, especially residential real estate couldn’t be hotter.

We have long been worried that real estate prices in the U.S. (particularly in markets on both coasts) have turned into speculative bubbles. Luckily, we stood on the sidelines and have not shorted any of the housing-related moon shots. But as the run up in homebuilders has intensified in recent weeks, even as Fannie and GM are sputtering, and the 10-yr backed up to north of 4.5%, we thought they deserved a second look. Upon doing so we found the same problems that have always bothered us about the industry – no free cash flow!

Now, as we are well into a multi-year expansion in housing, we still find it puzzling that the homebuilders as a whole can’t generate a nickel of cumulative free cash flows. Large and plentiful net income figures get lost on the way to the cash flow statement as gaudy land and inventory stockpiles



mount on the balance sheet. The chart below shows three such homebuilders DR Horton (the most acquisitive homebuilder of the bunch), Pulte (large middle of the road builder), and Toll Brothers (the high-end player known for \$635,000 average selling prices):

		<i>(9/30 fiscal years)</i>								
DR Horton	DHI	1999	2000	2001	2002	2003	2004	3/13/2005	ltm	Cumulative
	net income	159.8	191.7	257.0	404.7	626.0	975.1	1,030.0		2,614.4
	free cash flow	(186.8)	(152.4)	(90.6)	(129.9)	374.7	(477.7)	(887.5)		(662.7)
	inventory	1,866.1	2,191.0	2,804.4	4,343.1	5,082.3	6,567.4	7,493.3		
	tangible book	797.6	969.6	1,250.2	2,269.9	3,031.3	3,960.7	4,190.1		
	diluted shares	173.4	169.7	173.7	211.9	229.3	237.3	237.8		
x	market price	\$ 4.27	\$ 6.38	\$ 8.81	\$ 11.99	\$ 21.45	\$ 32.94	\$ 41.09		
	market cap	740.3	1,082.4	1,529.9	2,540.5	4,918.6	7,815.0	9,771.2		
	price/earnings	4.6	5.6	6.0	6.3	7.9	8.0	9.5		
	price/book	0.9	1.1	1.2	1.1	1.6	2.0	2.3		
Pulte	PHM	1999	2000	2001	2002	2003	2004	3/13/2005	ltm	Cumulative
	net income	178.2	188.5	301.4	453.6	624.6	986.5	986.5		2,732.9
	free cash flow	15.1	23.3	(418.8)	125.6	(340.6)	(904.4)	(1,130.0)		(1,499.8)
	inventory	1,792.7	1,896.9	3,811.6	4,277.6	5,510.8	7,390.8	7,390.8		
	tangible book	1,093.3	1,247.9	2,276.7	2,760.4	3,448.1	4,522.3	4,522.3		
	diluted shares	87.6	84.3	100.6	123.5	125.7	130.1	130.7		
x	market price	\$ 10.80	\$ 20.57	\$ 21.98	\$ 23.70	\$ 46.65	\$ 63.80	\$ 73.75		
	market cap	946.6	1,733.9	2,212.2	2,926.8	5,865.3	8,301.5	9,639.6		
	price/earnings	5.3	9.2	7.3	6.5	9.4	8.4	9.8		
	price/book	0.9	1.4	1.0	1.1	1.7	1.8	2.1		
Toll Bros.	TOL	<i>10/31 fiscal years</i>								
	net income	101.6	145.9	213.7	219.9	259.8	409.1	409.1		1,350.0
	free cash flow	(144.4)	(12.7)	(147.6)	(85.3)	(72.3)	40.6	91.2		(421.7)
	inventory	1,443.3	1,712.4	2,183.5	2,551.1	3,080.3	3,878.3	4,145.7		
	tangible book	616.3	745.1	912.6	1,129.5	1,476.6	1,920.0	2,108.6		
	diluted shares	74.9	74.8	77.4	75.5	75.5	81.2	83.0		
x	market price	\$ 18.62	\$ 40.88	\$ 43.90	\$ 20.20	\$ 39.76	\$ 68.61	\$ 81.65		
	market cap	1,394.1	3,058.8	3,396.4	1,524.7	3,003.5	5,568.7	6,780.4		
	price/earnings	13.7	21.0	15.9	6.9	11.6	13.6	16.6		
	price/book	2.3	4.1	3.7	1.3	2.0	2.9	3.2		

Cumulatively, you can see these companies generated \$6.7 billion in net income over the last 6 full years, yet free cash flow totaled a negative \$2.6 billion!

Meanwhile housing related players such as Home Depot and American Standard continue to generate sizeable amounts of free cash flow as they grow albeit more slowly. Even Lowe's has gotten into the act



of generating meaningful amount of free cash flow in the last 2 years. The details are shown below in the table:

			<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>Cumulative</u>
Home Depot	HD	net income	1,614.0	2,320.0	2,581.0	3,044.0	3,664.0	4,304.0	17,527.0
		free cash flow	(397.0)	(135.0)	(762.0)	2,570.0	2,053.0	3,037.0	6,366.0
Lowe's	LOW	net income	809.9	672.8	809.9	1,023.3	1,471.0	1,877.0	6,663.8
		free cash flow	(332.1)	(275.2)	(1,202.0)	(586.1)	334.0	709.0	(1,352.3)
American Standard	ASD	net income	138.3	315.2	295.0	371.0	405.2	313.4	1,838.1
		free cash flow	113.8	173.9	271.0	411.6	435.6	502.2	1,908.1

So why don't the homebuilders generate any cash? Well, it is largely because of their tremendous growth and insatiable demand to build their revenues and net income. This unquenchable growth thirst requires land and lots of it! The perceived shortage of land has led many to build a healthy portfolio of homes and land to fill the current backlog and the backlog of tomorrow.

We have long viewed the hallmark of a great business is the ability to generate free cash flow while growing. Plenty of businesses can pour money down a marketing or capex or inventory black-hole and show nice earnings growth in the short to intermediate term. However, at the end of the day, it is the company that generates the highest free cash flow that wins the race.

The homebuilders today and largely over the last decade have taken current cash flows and plowed them and borrowed capital (debt/EBITDA ratios have improved with earnings growth; however, absolute debt levels are rising along metrics such as debt/operating cash flow) into an ever increasing amount of inventory in the hopes of turning larger and larger backlogs into free cash flow that can be removed out of the business when things slow. Which, we guess wouldn't be the worst strategy in the world except that nine months to a year after the bubble bursts we think that demand won't merely slow, but rather come to a complete standstill. The fence sitters are already long a house, in fact, the buyers are now increasingly nothing but speculators (33%) according to the National Association of Realtors - so much for Alan Greenspan's quip that frictional costs of home owning prevents wide scale housing speculation. We can thank instant mortgage approvals and zero down schemes for that!

In comparing a Lowe's or Home Depot, we can see how current operational cash flow is put into new stores which will produce cash flows for many years in the future. They will be hurt by a housing slowdown, but it will be far from dire given the strength of their balance sheets. The homebuilders could be stuck with a wad of inventory that is not as easily moved by discounting like a pair of pliers from Lowe's.

But wait till you see that a slowdown in housing can't really happen when backlogs are at record levels. True, most homebuilders have a large degree of visibility nine months or so out, but it is after the nine months that worries us. Demand will likely dry up. Higher rates and weakening lender support in the form of Fannie, Freddie, General Motors, and a host of less risk tolerant securitized mortgage players may make financing more difficult at exactly the same rates back and consumer incomes are squeezed. We are a debt loving society that makes us more susceptible to a credit crunch. The massacre that



occurred in manufactured housing and the 2/3 tumble in units peak to trough may look eerily similar to the traditional housing market before all is done.

So while these homebuilders don't generate any free cash flow, and a slowdown of their torrid growth may make them generate free cash improvement in the very short run, longer term the problem remains that P/E ratios are now pushing 10x earnings (historically very high for such a volatile business with nearer to the peak than the trough) and price to books have largely moved to over 2x, again historically very high considering the appreciation land has shown. Homes are large ticket items that are extremely rate sensitive no matter what managements tell you. The fact is that they have no clue what home sales will look like if rates backup 200 or 300 bps. Remember that throughout history the busts have been proportional to the booms and this has been a once in generation boom. Bottom line, stay away from the homebuilder stocks!

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