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## THE TEXAS HEDGE REPORT

Steven McIntyre and Todd Stein, CFA

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### THE HOUSING MARKET HAS TURNED

Up until now, we have been dead wrong in believing that the housing market would exhaust itself, sell off dramatically in certain places, and cause tremendous pain in the U.S. economy. Instead, a nation hooked on debt has taken that debt addiction to a new level by propelling housing to ever higher levels over the last couple of years as the Fed was kind enough to panic and cut rates to near zero after 9/11 in an attempt to avoid a meaningful recession. This simply shifted stock market speculation to housing speculation.

Real estate appreciation and the resulting wealth effect gave the ability to millions of homeowners to tap elevated home equity levels as well as refinance at lower levels (though often on an adjustable basis). So the American consumer became quite flush with cash. And like any good American, he or she chose not to save that cash but to buy lots of stuff. Luxury automobiles, boats, jewelry, home improvements, and furnishings have all seen noticeable upticks in sales thanks largely to the cash people freed up from their home.



It has long been our contention that this would come to a spectacular end with housing prices cooling off nationally and likely falling meaningfully on the frothy East and West coasts. This slowdown in real estate would likely portend to a good deal of job losses in the mortgage broker, real estate agent, and construction industries. Real estate, just as it helped us avert a meaningful recession in 2001, will likely be what pushes us into an economic malaise in 2006-2007. Given this belief, we have watched the U.S. homebuilder companies with keen interest as they would likely be on the leading edge of a housing slowdown and give clues as to just how bad it will get.

Homebuilder stock bulls have said that even if housing slowed it would be a “soft” landing because of the demographic trends (population growth and higher home ownership rates among U.S. households) and the ability of large homebuilders to pick up market share in a still very fragmented market with a lot of mom and pop builders. Those arguments have some validity and brilliant fund managers like David Einhorn at Greenlight and Jeff Gendell at Tontine have made sound cases for why a housing shakeout won't be that disastrous for certain builders. They may be right on that score, but as a whole we suspect that homebuilders' stocks and earnings will be under great pressure for years to come. We have never liked their balance sheets, and have been disappointed in their lack of free cash flow as all building profits and then some were plowed back into larger and larger amounts of overvalued land and home inventories. Likewise, though builders have been smarter about limiting their spec building of units (which was seen in the late 80s when many homebuilders last had problems), the spec building stupidity baton has been passed to the individual real estate “investor” crowd. Ara K. Hovnanian, the CEO of large homebuilder Hovnanian Enterprises (ticker: HOV) recently said on a company conference call that, “[real estate investors] have largely pulled out...Investors were a bigger part of the market than many thought, including ourselves.....would be flippers are not only not buying new properties, they're selling what they already own, adding to the record number of homes already on the market.”

Homebuilder stocks (after decades of price appreciation) are starting to come under serious pressure as depicted by a 30-50% decline in the last 6 months seen in the chart above. Investors are starting to realize the tremendous earnings variability in most homebuilders. Homebuilders' earnings sky-rocketed very quickly over the last couple of years and it appears that these earnings can disappear perhaps even more quickly.

In article titled, “Builders Crumble Under Pressure” at *TheStreet.com*, A.G. Edwards analyst Greg Gieber is quoted as saying, “If it is not already painfully apparent, the soft-landing thesis for the homebuilding industry is dead.” The article goes on to list the scores of homebuilders that have warned in the latest quarter. Standard Pacific Homes saw new orders in April and May fall 41% because of cancellations and weak demand in California, Florida, and Arizona. Ryland, Toll, and Pulte all recently cut Q2 numbers, while small builder Technical Olympic sees its Florida-based company's net orders down 25-40% in Q2. Gieber went on to say that “The problem is a significant inventory overhang [at least a half million units that are vacant and for sale ~ and growing ~ per estimates based on Census Bureau data] and falling fundamental demand that should continue to trail downwards in a likely forthcoming environment of a weakening economy and rising longer-term mortgage rates.”

This past Monday, WCI Communities, the large Florida based homebuilder specializing in high rise homes, said it expected earnings to miss Q2 estimates. WCI said that its second-quarter order activity is “well below year-ago levels, weighed down by sharply lower traffic at many of its Florida communities,



and its decision to delay the release of several of its towers due to softness in market demand. For the first two months of the second quarter, combined WCI homebuilding orders declined almost 50 percent over the same period last year.”

These stocks appear tantalizingly cheap with trailing P/Es anywhere from 3-8x earnings. However, we have no faith in the earnings of these companies as they are not backed up by actual free cash flow. New orders are dropping 20-50% year over year in many cases. If the housing market, particularly because of the rampant stupidity and absence of lending standards in writing home mortgages, comes apart at the seams, then the ability of these homebuilders to generate earnings anywhere close to what they have made in the last couple of years is highly questionable. We would avoid homebuilder stocks like the plague despite smart people we respect taking a liking to them here. Higher margin of safety investments than homebuilder stocks at these prices exist elsewhere. Just ask the homebuilder execs who have sold shares hand over fist in recent years.

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