Michael Brush

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Insiders are bailing on home-builder stocks

The long-term forecast for new homes might be good, but right now, rising mortgage rates make investors -- and company officers, apparently -- nervous.

By Michael Brush

Is the housing boom doomed?

You don't have to squint to see the writing on the wall. Ever since mortgage rates bounced back from their lows reached in June, home loan demand has sputtered -- falling 13% in a single week in late August, for example. And housing stocks, which were among the biggest winners in the last year or so, look like they've peaked.

Now it looks as if mortgage rates could keep rising over the next 12 months, increasing the cost of home buying even more. As the economy recovers, bond investors will drive market interest rates higher, demanding bigger returns to offset growing inflation risks.

Industry insiders insist that the prospects for home sales and housing stocks remain rock-steady. But you might find it hard to listen to them with a straight face. That's because home-building executives have been bailing on their own company shares in huge volume. One major home builder saw 10% of its entire market cap traded away by top execs recently.

More on the selling binge in a moment. First, let's give the bulls a chance. Here's why they think it still makes sense to own home-building stocks despite the real risk that rising mortgage rates will kill demand.

If the economy grows enough to drive mortgage rates higher, employment and consumer confidence will increase, too. And that will support housing demand. For example, when mortgage rates advanced 1.8 percentage points (from 6.8% to 8.6% on 30-year fixed-rate loans) between the summer of 1998 and the summer of 2000, consumer confidence and employment gained too, says Matt Moyer, who handles investor relations for the home builder **Centex** (CTX, news, msgs). That kept housing demand alive. Centex earnings grew an impressive 20% on average each quarter in that time frame. What's unknown is the level at which demand for mortgages really starts to crater.

NVR

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Demand for housing outstrips supply by a healthy amount. It's natural to want to halt nearby home construction the second you buy a house, so politicians have created thickets of local building regulations in communities around the country. In some areas, this has doubled the time it takes to get approval for new units, compared to a few years ago. "You have an artificial cap created by government regulation across the country that keeps supply down," says Joel Rassman, the chief financial officer at **Toll Brothers** (TOL, news, msgs). Demand, meanwhile, marches on, thanks to immigration, the desire for second homes, the aging of the population and other mega trends. Rassman puts what he calls the natural demand for new homes at 1.8 million to 2.1 million per year. (That's on top of existing home sales.) But building authorities are issuing 1.5 million permits per year on average.

PULTE

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Because of huge changes in the housing markets, large, publicly traded home builders are stealing market share from smaller, private builders. The big boys are stronger because they have better access to cheaper capital. They have been moving rapidly to expand in fast-growing markets, where they can use their bargaining power and sophistication to assemble land for projects and get local approvals. So even if the housing market softens nationally, big players will still grow. The big public home builders include: Centex, **Lennar** (LEN, news, msgs), **D.R. Horton** (DHI, news, msgs), **NVR** (NVR, news, msgs), **Pulte Homes** (PHM, news, msgs), **Beazer Homes** (BZH, news, msgs), Toll Bros., **Hovnanian Enterprises** (HOV, news, msgs), and **Ryland** (RYL, news, msgs). The top 20 home builders last year had 24.4% of the market, compared with 10.9% just 10 years ago, says Wachovia Securities analyst Carl Reichardt.

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Housing companies are better managed now, and that makes them more prepared for any market downturn. "These are good companies with good cash flows, and they are not doing dumb things with it like building on spec," says Ron Muhlenkamp of the **Muhlenkamp fund** (MUHLX), which holds several housing stocks. Return on equity at Centex, says Muhlenkamp, has been in the 18%-20% range for the past three years. That's almost double the level of a decade ago. (For a screen on housing stocks, click here.)

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Dramatic changes in the financials at Lennar over the past 10 years are fairly typical of the sector -- and they tell a similar story of a company better positioned to weather a downturn for two reasons: Lennar carries much less land on the books, and it has tilted its borrowing mix to long-term debt, which is easier to manage in downturns.

"Ten years ago, we had six years of land owned on our balance sheet and debt maturity of three years," says Bruce Gross, the chief financial officer at Lennar, which operates in California, Texas and Florida, among other markets. "Today we have two years of land owned and our debt maturity averages eight years. So what has changed is this industry used to have a large, illiquid asset called land, and debt that matured a lot sooner than the land was used. Today it is the reverse."

Two big problems

All of these ideas make a lot of sense. But even a casual observer must find it odd that while home-building companies are making these points publicly, insider sales are piling up like candidates in a California recall election.

Top managers at NVR, for example, have sold an impressive $300 million worth of stock since early May. That amounts to 10% of the entire market cap of the company. Chairman Dwight Schar was the biggest seller, getting rid of $173 million worth of stock. William Inman, an officer, sold $67 million, and chief financial officer Paul Saville dumped $55 million worth. Since the insiders began selling in May, NVR shares have bounced around in a picture-perfect trading range between $400 and $440 per share.

Meantime, Bruce and Robert Toll, directors at Toll Bros., have sold at least $70 million worth of their company's stock since June 12. Toll Bros. shares declined to $26 from the $30-$32 range in mid-June, where insider selling was heavy. Recently the shares recovered to around $30.

How bad does all this insider selling look? "It's aggressively negative," says Michael Painchaud, research director at Market Profile Theorems, a buy-side research boutique in Seattle that has a sell rating on the group because of the insider exodus.

Home-building companies respond that insiders have -- and retain -- large exposure to their own shares, so you would expect them to sell to diversify. But they had the same exposure when their share prices were much lower, and they weren't selling back then, replies Painchaud.

Besides, selling is so widespread, it sends an unambiguous signal. "When I see it on an industrywide level like this, it tells me that something else is going on, and the sales are probably more than just casual," says Painchaud.

Market Profile Theorems ranks nearly 100 industries on a scale of 1 to 10 for insider trading, with 10 being the most desirable rating. Massive insider sales are so prevalent with home builders (Centex is a rare exception) that the industry rates a rock-bottom 1.

Investors won't be convinced rates don't matter

The second problem for home-building stocks is that, as much as the sector may have changed, investors will never be convinced that home builders are immune from rising mortgage rates. That means jittery investors will be dumping home-building shares whenever they get signals that the economic recovery is for real. "The problem is these stocks trade off perception," says Chris Berrier, who follows the home-building group for the T. Rowe Price mutual fund group. "So if people believe that rates are going up, these stocks tend to lag regardless of what the fundamentals are. Although the Fed says it is on hold, if all of the sudden you have 5% GDP growth, people are going to start to worry about inflation again, and that will have an impact on interest rates."

Which will spark selling in home-building stocks.

The scenario is more likely than you may think. Chris Probyn, the chief economist at State Street Global Advisors, points out there are several convincing signs the economy is picking up nicely -- from increasing retail strength to stronger orders and shipments. He thinks an expected $60 billion in economic stimulus in the third quarter, from tax cuts and government spending increases, will be more than enough to offset losses from declines in mortgage refinancing.

James Paulsen, the chief investment officer at Wells Capital Management, believes that stimulus, plus the cheaper dollar, the increase in the money supply and low interest rates, will spark enough growth to drive 10-year Treasury yields up to 5% by the end of the year. The current yield is around 4.55%. By the end of 2004, he thinks 10-year yields could be up in the 5.5%-to-6% range. The yield on 10-year notes is important, because it is often used as a benchmark in setting mortgage rates. (A very rough rule of thumb on mortgages is to add 1.4% to the 10-year yield to get to the 30-year rate.)

A move like that would drive mortgage rates high enough to slow down the housing market, says Paulsen. "The housing market might start to weaken noticeably in the last half of next year." But housing stocks will react much sooner, because investors will price in the housing slowdown ahead of time. "I do think you are late in the game on housing stocks," says Paulsen.

So what's an investor to do?

Given all the headwinds, housing stocks aren't a buy here. (For a chart of how the housing stocks have performed as a group, click here. To look at a specific time period, click on period in the gray zone in the chart.)

But nor are they doomed in the long term. Because the dynamics of the sector have changed, they probably won't sink to lows seen in the early 1990s when business was bad, or in the late 1990s when investors ignored these stocks during the tech craze.

Astute traders will be watching for a trading range to work, as bulls and bears battle it out with each piece of news that sheds new light on the strength of the recovery.

The top end of a trading range might be demarcated by the prices where insiders sold just below the highs in May, June and July. And the bottom? Frankly, that's hard to know right now. But Eric Miller, a Heartland Advisors portfolio manager who sold home-building shares in the recent rally, has a good guess. “I would love to see the stocks get hit by 10% or 15%. Then I would buy some,” he says.

That would suggest Pulte, for example, is a buy in the mid- to upper-$50 range, Centex in the mid- to low-$60 range, and D.I. Horton around $24. Given the potential negatives for the sector, it makes sense to wait patiently -- very patiently -- before getting into these stocks.

At the time of publication, Michael Brush did not own or control shares in any of the companies listed in this column.

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