

October 15, 2010

**Dear clients and colleagues,**

We are now in Q4 and companies are reporting strong year-over-year sales and profit growth for Q3. This is the last quarter of easy comparisons and the market will soon look to 2011 and beyond. Expected earnings for 2011 were revised downwards for the first time last week.

We read in a research paper that 80% of fund managers were trailing the S&P500 at the end of Q3 and over 25% by more than 5%. As a result, the paper concluded that the Beta (risk) trade will dominate the market in Q4 as managers try to catch up. September saw the strongest monthly returns since 1934. Couple that with QE2 and a Fed that does not want to interfere with mid-term election outcomes, and we have an explosive recipe for very strong markets into year end.

Just like the various stimulus programs which have the short-term effect of bringing forward future demand, there is a risk we may see lower future returns. However, with a longer-term horizon, the risk/reward of stocks over bonds seems very favourable.

The company we will profile this week has been in the portfolio since inception. It is the third largest homebuilder in the US, Lennar Corp. Are we forecasting a rebound in housing? Please read on.

**LENNAR CORP (LEN US-US\$15.89)**

[www.lennar.com](http://www.lennar.com)

***Business Overview***

Founded in 1954, Miami-based Lennar is the third largest homebuilder in the US, focusing on move-up homes. Lennar builds homes in 17 US states that experienced fast population and economic growth. In the last year, Lennar built and sold around 11,000 homes for an average price of \$240,000.

***Market Data***

Market cap US\$2.83B, cash US\$1.22B, total current assets minus total debt (short- and long-term) US\$1.148B, div yield 1.0%, P/E (11/2011) 24.6x, profit margin 3.6%, ROE 4.0%, insider ownership 11.6%, 1-year total return 7.4%.

***Target Market***

There are 115 million housing units in the US with around 71 million detached single family homes. The median age of housing stock is around 30 years.

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The US population growth is 3 to 4 million people per year and 1 million new households are created each year.

A normal long-term build rate should be around 2 million units per year.

In 2006, new builds were 2.1 million p.a.; we are now at 540k. Single family starts in August were at the lowest since data gathering started in 1963 when the US population was 190 million; it's now 308 million.

### ***Competitive advantages***

The industry is very fragmented. Although they have gained market share in the past 30 years, the top 10 builders still account for less than 30% of the market.

Lennar's competitive advantages are:

- Recognized brand name for quality and value;
- Strong balance sheet with over \$1 billion in cash;
- Owns and has options on a large inventory of permitted lots;
- Its distressed asset division (Rialto) allows the company to profit in the current market.

### ***Competition***

Other large builders include NVR (NVR US), DR Horton (DHI), Pulte Group (PHM). But the real competition presently comes from the large inventory of unsold and foreclosed homes. 3 million foreclosures are expected in 2010.

### ***Growth strategy***

The company's strategy is to acquire land in the fastest growing regions of the US, permit lots and build new communities.

In the current environment, the company has launched a distressed asset division. Rialto buys assets (finished and unfinished homes and land) at distressed prices from banks and other financial players.

In the past few years, the company has also started acquiring property for redevelopment in urban centers such as Manhattan.

### ***Risks***

The residential real estate market in the US remains very weak and could see a double dip.

Interest rates are currently at historical lows and a rise in interest rates would be negative.

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**Investment Theme**

Housing starts in August were at their lowest since data gathering started in 1963. In 1963, the US population was 190 million. Today it is 308 million.

House prices have declined around 30% since their peak. For new homes sold, the median price is now \$217K, around 12% lower than in 2006. To put things into perspective, the median house price in Canada was C\$330K. If curious, please read our commentary of August 13, 2010.

We believe that the market is very close to finding a bottom and should be much stronger in five years' time. We are not making a forecast for house prices but rather that demand for new homes will be much higher. And that is what is going to impact Lennar.

**Valuation**

Our target price is US\$26.70, an increase of 67% using a growth rate of 8%, a risk premium of 10% and payout at maturity of 60%.

Have a nice week.

Regards

The Global Alpha Team

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