November 15th, 2012

Dear clients and colleagues,

The US homebuilding sector has been home of the best performers this year, up 106% YTD. The derivative trade, i.e. hardware stores, constructions materials, etc. has also significantly outperformed the market this year. For example, Home Depot is up 49% this year and is at an all-time high.

Valuations for these companies are at multi-year highs. Despite the fact that the number of new homes built is up from around 500k units to 872k units last month, we are still far from the previous peak of January 2006 at 2200k units.

So, has the market already priced in a full recovery?

We were very optimistic that the housing sector had reached a bottom and would rebound. Our October 12th 2010 comment on Lennar summarized our thoughts. At that date, Lennar (LEN US) sold for $15.90; our target price was US$26.70. Today the stock sells for $38.28. We sold the stock at $27.50 at the end of March 2012, in part because it had reached our fair value, but also because it had exceeded the US$5 billion market cap threshold at which we sell to stay true to our small cap mandate.

At that time, we replaced it with Eagle Materials (EXP US), a manufacturer of wallboard and cement. We purchased Eagle in April and May 2012 at an average cost of $33. The stock is now selling for $53, a return of 60% in just 6 months. Following the acquisition of quarries and concrete plants from Lafarge USA, our fair value for Eagle has increased recently to $69.

The markets in the last few years have become driven by momentum and short-term trading. Intrinsic value is secondary in the short term. The homebuilding trade will continue as long as positive news on housing will continue and valuation will continue to march higher until then. However, the risk reward is becoming increasingly unfavorable.

Although we think house prices will continue a slow recovery***, we believe new home building momentum will slow greatly in the months ahead.*** We list our reasons below.

From September 2008 to February 2012, there were approximately 3.8 million completed foreclosures.

As of August 2012, approximately 1.3 million homes were still in foreclosures proceedings.

There are 11.4 million homes with negative equity. A huge shadow inventory that will come to market eventually.

Another 4.2 million homes are vacant and are considered excess supply.

In the last few years, builders aggressively reduced prices and offered incentives, often making a new home purchase a better option than an existing home. However, builders, facing strong demand, have raised prices a few times in the last 12 months, making existing home now more competitive.

The climb back up to 1.5 million single family home start is very far away in our opinion.

The percentage of US homeownership was 69% in 2005 is now 65%. We think it may even go lower as baby boomers are looking to downsize and as younger people do not see a home as an investment.

Finally, household formation around 1.5 million a year will continue to stay strong, assuming that 65% choose to be owner; we get to about 1 million home starts.

Therefore, we believe that homebuilders and the whole industry around it is now a risky trade with limited upside.

Have a good weekend.

Regards

The Global Alpha Team