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**AMBER KANWAR, BNN:**

Today in Hotpix, we're talking about the home building sector, which for a while has defied expectations, even in a rising rate environment. The home builders proved to be one of the best places to be in the market over the last year. It's up 50 percent versus the S&P 500, which is only up 14 percent. But since hitting those all-time high levels this summer, they have underperformed the broad market and are threatening to enter a bear market, which is a pullback of 20 percent or more from the peak. Joe Ahlersmeyer is an analyst at Deutsche Bank that covers this sector and he joins me now. Joe, thank you so much for being with us. I mean, we talked about why these home builders in the past had the hot hand because people are not moving out of their homes, so the supply is so down. So what's happened since then? Why have these stocks as a group pulled back so much?

**JOE AHLERSMEYER, DEUTSCHE BANK:**

Sure, and thanks for having me back, Amber. I think, first of all, let's kind of put two things aside. One is the fundamentals, which have been unchanged by what the stocks are doing, but two, what the stocks are doing relative to what we've seen in interest rates. So since really the early part of August, you've seen government yields rise, and that has pushed mortgage rates higher, which has a direct impact on affordability for home buyers, not yet clear exactly how significant that will be to the home builders, especially the public home builders results, but certainly investors looking at the stocks two months ago, seeing the rise in rates, got a little concerned and started to sell the stocks. We continue to look at home builders on a relative basis. We think that that's a winning strategy, both in good times and in bad. And so even today, with rates being where they are, we still think there's pretty good opportunities across that space.

**KANWAR:**

And so when you're doing it on a relative basis, for example, you like DR Horton, but you're a sell on Lennar, what are the criteria that you're kind of stacking up against each other?

**AHLERSMEYER:**

Sure, and it really comes down to, we look at these as investments, and any investment should be valued based on the timing and amount of the cash flows, and really what that comes down to with home builders is they are investing in land and then earning a return on that land as they construct homes and sell those homes to buyers. So we're looking at that return metric of profit relative to the invested capital necessary to run that home building operation, and really picking the ones where the returns are highest, the growth in that inventory investment is the best, and that's appropriately priced relative to those levels. With DR Horton, they have the best returns in the space, but naturally they're also the most expensive home builder. So when you're looking at it on that basis, you can't just say it's the best return generating home builder, you also have to say relative to that, it is inexpensive, or it's even relatively more inexpensive to other home builders who might be also earning high returns.

**KANWAR:**

All right, so that's the view on DR Horton. Your other ideas are maybe a little bit more off the beaten path, and maybe that's why they've held up relatively better. Let's use Core & Main as an example. First tell us kind of what they do, and as we take a look at the chart, you can see that it hasn't fallen victim to the same kind of pressures that the home builders have?

**AHLERSMEYER:**

Sure, and Core & Main is a distributor of building products, particularly pipe-related items, things that go into water works, but also land development for home builders. So in a way, this is still a housing play, but it is only a small proportion of their overall revenues. The reason it's held up better is there's a lot of company-specific idiosyncratic tailwinds that we felt like were underappreciated early in the year for a number of reasons. One, sort of being it's a new company, well, let's say it's actually not a new company, it's a new public company having IPO just a couple of years ago. But there has been, I would say, a lack of investor interest, or even just not even noticing that this company has such a good story because there's a limited float in the shares. There's a private equity firm that was- the sponsor to the IPO and has been selling down their shares as planned, and so the float has increased. People have become more interested, and are really starting to sharpen their pencils on some of the complexities around the capital structure, but really getting excited about the underlying business, which benefits from two main tailwinds, as we see it. One, the industry at large has been under-invested. The waterworks industry in the United States, the municipal waterworks industry, is under-invested, so it's in a state of disrepair, and that is a stable stream of business for this company going forward for several years to come, and actually benefits from infrastructure spending tailwinds as well around that new bill that was signed a couple years ago, and has yet to start contributing to results. The other thing is the under-supply of finished lots for home building and communities that need to come online for builders to sell homes in , and even if we have higher interest rates in demand in sales centers this week, the builders are going to be developing land, and they're going to need those products that the distributor, Core & Main here, is providing with 20% of their revenues.

**KANWAR:**

Yeah, your last pick is Beacon Roofing Supply. What strikes me with both of these is the multiples are definitely cheaper than what you're able to get in the market. Beacon had been growing at a double-digit pace, at least on a top-line basis, but it looks like the forecasted revenue is set to slow down. Does that explain why the stock has pulled back as well?

**AHLERSMEYER:**

Well, look, I would say that the reason that the forecasts are where they are is there's concern that current results are benefiting from excess demand from storms, not only the volume that comes along with that, but the pricing that that helps with, because if demand is very strong and capacity is relatively limited, that's going to be supportive of pricing. There's a 5% plus price increase that went in in May, and then another one that followed in August, because demand from storm-driven- demand has been so strong. So concerns that once that volume kind of works its way through the sell-through, you're going to have potential volume declines and pricing pressures. That is not a concern we necessarily have. We're certainly looking into 2024 to understand the structural part of the demand equation, not just the storm part. But if you look at the demand for shingles, 80% of it is R&R-driven. There's only about 20% or less that is new construction. And within that 80% only a small portion of that is from storms. A lot of it just comes from repair of existing structures that just need it, because it's been so long since the roof was put on, and really it just comes down to the equity that homeowners have, allows them to pay for discretionary remodels, insurance often pays for the repairs, and so the stable nature of that business we think is underappreciated and may be underappreciated because many of the peers in building products distribution really are exposed to construction, not repair and remodeled.

**KANWAR:**

Joe, thanks so much. We got to leave it there, but thanks so much for your perspective, that's Joe Ahlersmeyer, joining us from Deutsche Bank.