

A homebuilder that may surprise to the upside

By Sunil Vidyarthi

If you didn't know what a "run on the bank" means and what it can do to the financial world, including your investments, you just got a high school diploma by Wall and Bay Street professors.

Now let me not be an alarmist and suggest that the worse is yet to come or be a Zen master and suggest that all will work out for the best, but let me be an opportunist and suggest that there are markets, regions, stocks and sectors that still look promising.

Many stocks have dropped significantly and perhaps unjustly. One such market is Mexico and the stock **Homex Development Corp.** (HXM-NYSE, \$56.65) Whether it could get worse before better depends on whom you pay attention to: Chicken Little or the monk?

Look for the stocks which have been mistakenly thrown out with the bath water. So what is that dirty sector at this moment? It is definitely housing and mortgage and finance. Now the problem seems to be confined to U.S.A. so far, but the effects are being felt all over the world, in far away lands like Australia, which has seen its currency pummelled and next-door neighbor Mexico, which is expected to suffer if there is a U.S. recession.

One country I am particularly keen on is Mexico. Nearly three years ago, I recommended



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Homex, arguing that affordable housing ought to be a growth industry in Mexico. It has been so, as this stock has gone from the \$20s to over \$65 recently. It has seen its earnings grow at well over 50 per cent a year, and it is still trading at 12 times next year's earnings per share.

The demographics as expressed on the company website are in still favor of continuing prosperity and the need for housing in Mexico. Mexico's population is nearly 103 million, growing at 3.0 per cent a year. Current deficit is 4.3 million homes, with the requirement for new households approaching 766,000 annually.

Some 23 million Mexican families are above the average, minimum monthly wage required by the banks and Sofolesto (equivalent to our CMHC) for a mortgage loan — and therefore are potential clients for Mexican home builders.

The company recently compared U.S. mortgage practices with those in Mexico. U.S. sub-prime borrowers are comprised of low- to middle-income households with bad-credit history and limited borrowing capacity. Mexico's AEL Mortgage Market is mostly comprised from the 16-million prequalified subscribers who must meet a minimum-wage guideline. They pay a down payment of 10 to 15 per cent. Monthly loan payments are deducted directly from

borrowers' pay cheques.

But U.S. homebuyers using the infamous adjusted-rate mortgage, which requires a down payment of from zero to 15 per cent, become habitual refinancers to meet their mortgage payments. Each time they do this, borrowers add thousands in fees and costs to their loan balances. Great news for the lenders, until the borrowers can't pay, like now.

Homex is Mexico's largest and most diversified home builder with operations in 30 cities in 19 states and leading positions in Mexico's four largest markets (State of Mexico, Guadalajara, Monterrey and Tijuana) The last three-year revenue growth rate was 60.5 per cent compounded, with the net income growing at 57.7 per cent — hence a 300 per cent rise in the stock price in the last three years.

Homex's vision is to attend to the four drivers of the country's GDP: bureaucrats at state capitals, border cities, industry centres and tourism on the Pacific coast. It is focused on cities with high GDP and employment like Coatzacoalcos, Queretaro, Ensenada, Torreon, Cancun and Cuernavaca. Covering 73 per cent of Mexico's population, Homex has the highest footprint among its competitors.

The company focuses on affordable entry-level housing (77.4 per cent of 2Q07 revenue and 91.5 per cent of 2Q07 sales volume). These are 450-850 square feet, one-three bedrooms, one-bath

units for US\$18,000-US\$40,000 sales price.

The next biggest segment for Homex is middle-income housing (22.6 per cent of 2Q07 revenue 8.5 per cent of 2Q07 sales volume) 820 -2,000 square feet, two-four bedrooms, two-four baths, US\$41,000 -US\$200,000 sales price. At these prices, which obviously have not zoomed along with the rest of the world, many retiring boomers may be heading out to the warm climes after Florida is all full up.

Two big questions that remain before I make a commitment to buy this stock even though it has tripled since I first recommended it, are whether Mexico will remain buoyant even if U.S. slumps and if so whether Homex is still well priced. As in Canada, Mexico also has an enormous base of natural resources including energy and metals, which should be tied in more with China than California.

While most analysts have reduced their growth forecast from a torrid 50 per cent range, it is still a 20 per cent per year grower. It is quite possible that the surprises from Homex may be positive rather than what we see among U.S. builders. Four analysts expect EPS of \$4.28 for 2008, making this a reasonable priced stock at a PEG ratio of 0.96. It definitely qualifies for purchase if there is a pullback or a sustained malaise in the markets into this fall.

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