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America the homebound

Evan Lorenz writes:

Before the bug barged in, housing—land, structures, mortgages—was on track for its best year in more than a decade. Now in progress is a mid-pandemic update. To anticipate, we remain bullish on homebuilder Lennar Corp. (LEN on the New York Stock Exchange) and on the preferred shares of the mortgage real-estate investment trust AGNC Investment Corp. (the identical ticker on the Nasdaq).

"I'm quite sure about where we end up," Marvin Shapiro, CEO of Avanti Properties Group and long-term housing bull, tells me, "with relatively robust housing conditions particularly at the affordable end. What I don't know is how long a pause we are going to take."

Leverage at the level of the individual citizen was no impediment before commerce stopped short. From their 2007–09 peaks, household debt to GDP has declined to 65% from 87% and debt-service costs as a percentage of disposable income to 9.7% from 13.2%. House sales, both of the new and previously owned kind, rose by 8% in February at a 6.5 million annualized pace, fastest in 13 years.

And neither was affordability a stumbling block, tight inventories and a shortage of entry-level units notwithstanding. In January, house prices climbed by 3.9%, according to the S&P CoreLogic Case-Shiller 20-City Composite, well above the corresponding 2.3% rise in the CPI but hardly enough to render the average house unaffordable. Last month, builders started work on 1.6 million units, measured at an annual rate. It was a level that, although higher by 450,000 from the year before, was no greater than that needed to meet new household formation and obsolescence.

Then the economy stopped and finance erupted. Between March 3 and 18, the price of a typical Fannie Mae 3% coupon mortgage-backed security dipped to 101.6 from 103. The Fed's pledge to buy up to $50 billion per day of those securities cut short the sinking spell.

But there's been no such snapback for mortgage paper not under government protection. Thus, for instance, the CitiMortgage Alternative Loan Trust Series 2007-A4, a pre-Lehman-crisis mortgage-backed security stuffed with alt-A loans (i.e., credits falling between subprime and prime), dropped to 70 cents on the dollar from par and change at the end of February.

Over the weekend of March 21, Annaly Capital Management, Inc. decided there was no sense in waiting until Monday to lighten its own portfolio of non-agency MBS. On Sunday, Annaly issued a BWIC—bids wanted in competition—for $400 million of non-agency MBS, of which the REIT reportedly moved only $100 million's worth.

Annaly's haste did nothing to boost confidence in a market accustomed to working only weekdays. "I ran dealer desks for over 20 years," Eric Rosen, CIO of Reef Road Capital and former head of credit trading at JP Morgan Chase & Co., told Bloomberg two Tuesdays ago. "And I never recall a BWIC on a weekend."

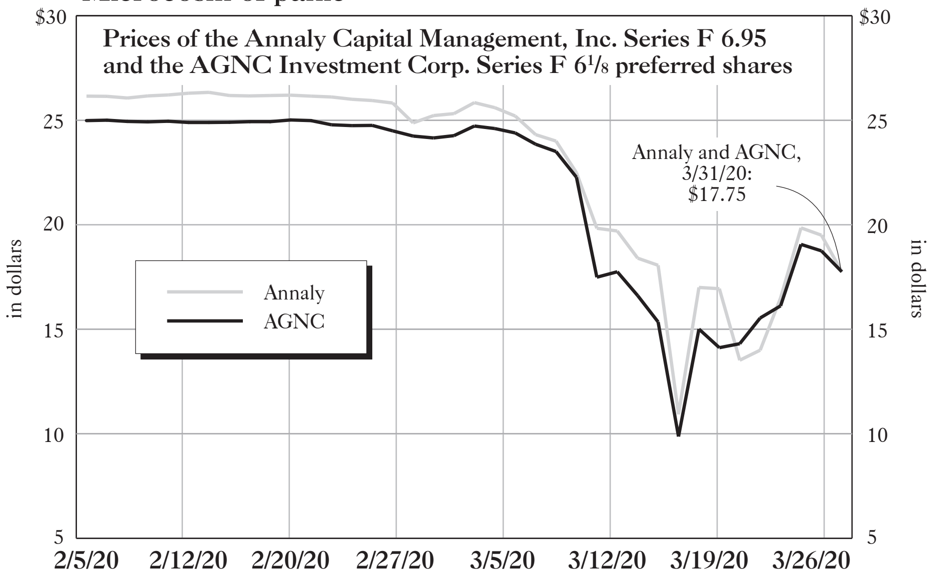
On Monday, March 23, New York Mortgage Trust failed to meet a margin call. On the 24th, Invesco Mortgage Capital followed suit. On the 25th, Royal Bank of Canada began selling more than $600 million of commercial mortgage-backed securities, some of which it had seized from mortgage REIT AG Mortgage Investment Trust in lieu of payment of additional margin.

Bullish analyses of a pair of mortgage REIT cumulative preferreds, the Annaly Series F 6.95s and the AGNC Investment Corp. Series F 6⅛s, featured in these pages two weeks ago. As both securities are senior to the corresponding common in their respective capital structures, they are, to that extent, armored against adversity. As we went to press on March 17, they were priced to yield 9.9% and 10.1%, respectively.

By the time the digital edition of *Grant's* hit the wires after the market closed the next day, the Annaly and AGNC issues had sunk to $10.93 and $9.87 on $25 par values, to yield 15% and 15.8%. They became even cheaper before stabilizing and, within one week of the *Grant's* publishing deadline, actually doubling. At this writing, the Annaly issue changes hands at $17.75 to yield 9.1%, its AGNC counterpart at $17.75 to yield 8.5%.

Perhaps you, gentle reader, bought each preferred at the low and held on for that quick two-bagger. And perhaps you are now wondering what the geniuses at this periodical have to say for themselves. We say, in the first place, that we know good luck when it stares us in the face. Second, we know that the kind of Federal Reserve intervention of which we so heartily disapprove was the agent of that neat capital gain. What might have happened to the mortgage market in the absence

Microcosm of panic



source: The Bloomberg

of these gigantic intrusions into the business of price discovery, we have no idea. Nor were we fully aware of the structural fissures that summoned the federal cavalry.

In the wake of these extraordinary events, AGNC strikes us as the relatively safer of the two income plays. On Dec. 31, all but $1.6 billion of the company's $107.9 billion portfolio comprised the federal-agency securities that the Fed is buying with both hands. By contrast, $14.5 billion of Annaly's $127.4 billion portfolio is invested in non-agency paper, i.e., the kind so hurriedly placed on offer two Sundays ago.

"We're obviously cognizant of the fact that we're a levered portfolio and we can't make big bets," AGNC chief Gary Kain told dialers-in on the Jan. 30 earnings call. To reduce the risk inherent in any leveraged financial structure, Kain and company try to identify MBS for which the risk of prepayment is relatively low. The all-around objective, says management, is to build a hedged portfolio whose book value is relatively inured to the damage inflicted by plunging interest rates. Widows and orphans know it, but we'll say it anyway: These are aspirations on the part of the AGNC front office, not guarantees.

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REITs, which collectively own about a half-trillion of MBS, are at one end of the housing-finance mortgage chain. Non-bank mortgage lenders, originators, nowadays, of many of the loans that supply a securitization, are at the other. "Non-banks are now 80%-plus of FHA-insured mortgages, and they're around 65% of Fannie and Freddie," Rick Palacios, Jr., director of research at John Burns Real Estate Consulting, tells me. "The traditional banks have essentially backed away from the mortgage market, especially from FHA-backed loans. And so, our concern has always been that the business model of the non-bank is just so much riskier than a traditional bank. They're just very thinly capitalized. They depend on short-term warehouse funding from, oh, by the way, big banks."

When a mortgagee misses a payment, the servicer is on the hook; it must reach into its own pocket to advance principal or interest to the relevant mortgage trust. Naturally, cash-flow problems arise. While Fannie and Freddie eventually make their servicers whole, other federal-loan programs—e.g., VA and FHA loans administered by Ginnie Mae—do not. This could make April 20, the date when servicers must advance payments to Ginnie Mae, a day to remember.

If a quarter of Americans failed to pay their mortgages for three consecutive months, the Mortgage Bankers Association calculates, servicers would suffer a $36 billion loss. "Virtually no servicer, regardless of its business model or size, will be able to make sustained advances during a large-scale pandemic when a significant portion of borrowers could cease making their payments for an extended period of time," the CEO of the association, Robert Broeksmit, advises the Treasury. His solution is a lending facility specifically for—his members.

Pending that, or another, federal helping hand, non-banks are cutting loan issuance. "Due to the constant shifts and the inability to appropriately evaluate credit risk, we are pausing all loan activity for two weeks," warns one such originator, Angel Oak Mortgage Solutions, which, having originated $3.3 billion in loans last year, is among the larger of the breed. "This includes fundings and any new loan activity." Last week, Citadel Servicing Corp. announced it would stop issuing the kind of "non-qualified mortgages" that don't conform to government guidelines and that can't be sold to Fannie and Freddie.

"Either the U.S. government and/or Federal Reserve support the float for the loan-payment moratoria or the U.S. Treasury will need to make the payments on $10 trillion in [Fannie/Freddie] and [Ginnie Mae] bonds come April 25," Christopher Whalen, publisher of *The Institutional Risk Analyst*, advises by email. "Mnuchin will eventually figure it out."

Assume, then, that the mortgage business gets its federal backstop. According to press reports, the administration is already in discussion to sort out the details. If so, many of the planks of the bull case in housing remain in place, even with prospective buyers homebound.

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There are 39.6 million millennials between the prime home-buying ages of 28 and 36. It's easy enough to imagine these apartment- or basement-dwellers self-treating their cabin fever by planning the purchase of their first house. "Buyers that are already in the process are pleading with their builders to speed up construction because they want to get out of their apartments," Palacios says. "They want to have more space."

Before the virus struck, the United States was short three million or so housing units, nearly twice the aforementioned 1.6 million-unit pace at which the Lennars and D.R. Hortons and NVRs of the world were recently building. New starts will undoubtedly fall as builders deal with supply-chain snafus, sick workers, and difficulties getting local-government officials to approve permits and to inspect homes. At the same time, Americans will continue to procreate and apartment-induced claustrophobia will fester.

While 30-year mortgage rates spiked to 4.05% on March 19 from 3.55% at the start of the month, those rates are once again falling—last week, Freddie Mac reported a downtick to 3.50%. "The Federal Reserve's swift and significant efforts to stabilize the market were much needed and helped mortgage rates drop for the first time in three weeks," cheered Sam Khater, Freddie Mac's chief economist.

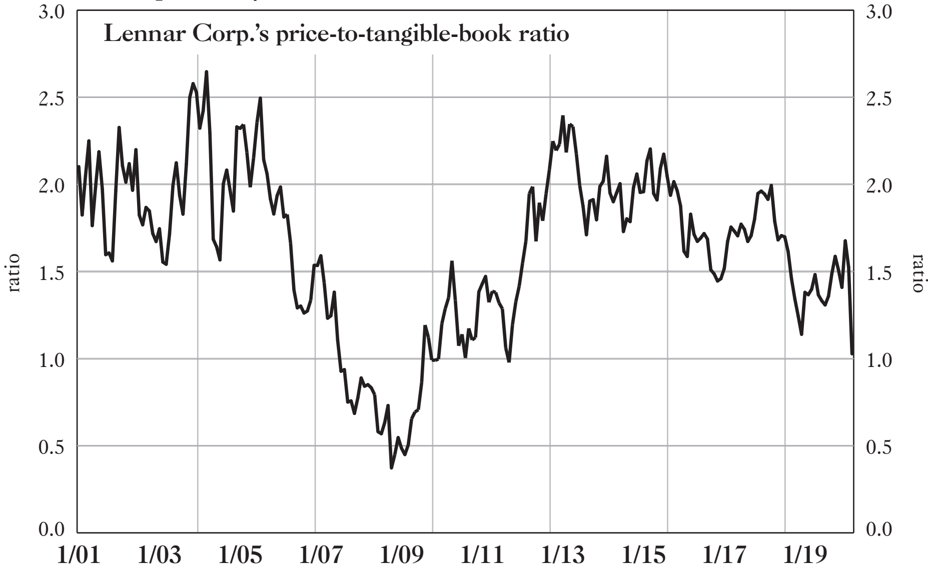
"This is not a financially or financial-sector-driven slowdown," Lennar chairman Stuart Miller opined on the March 19 earnings call. "It does not derive from an inventory build-up. It doesn't derive from an over-production of mortgages.... It is a true black swan [event]."

Lennar, America's biggest builder by revenue, delivered 10,321 houses and generated $4.5 billion in sales in the quarter ended Feb. 29. Building is not the company's only line of business—mortgage and insurance ($47.3 million in operating profit in the first quarter) and apartment-building development ($1.8 million) are part of the mix, too. But the homebuilding unit ($460.4 million) is what keeps the lights on, chipping in 90.4% of corporate operating income before overhead during the same three months.

Since we laid out the bullish case on Lennar last summer, the stock has sunk by 20% to $38.20 from $47.63, with stops at $71.22 and $29.35 in between (*Grant's*, July 26, 2019). Despite crisis-level share-price acrobatics, Lennar reported a strong first quarter with a 17% rise in home sales and an 18% bump in new orders. Based on the latest reported figures, LEN is trading at 6.6 times trailing earnings and pays a 1.3% dividend yield.

It doesn't count for much that new orders continued to grow in the first two weeks of March. "Businesses across the country like ours are searching for playbooks and institutional memory to help guide the way forward," Miller began the March 19 earnings call. "Those simply do not exist. There are no financial models to populate, and no views around our corners to illuminate. There is only management. Hands-on management working day by day and making adjustments, looking for signals and making decisions in an imperfect environment that will have to be considered and reconsidered as the landscape evolves."

Cheapest in years



source: The Bloomberg

Though revenues will undoubtedly come under pressure, the builders are not entirely defenseless. Lennar says it's taking some of the same countermeasures it deployed in 2006–08, by reducing outlays on land, land development and construction. Those tactics must have something to recommend them, as free cash flow doubled to $1.1 billion from $527.9 million over the course of those three difficult years.

As for the current tumult, it's a little concerning, according to the afore-quoted Shapiro, who buys and develops raw land for a living, that not a few builders are in denial about the severity of the downturn. "In each market we are in, dealing with the local representative or the local divisional president, they are still gung-ho under the circumstances," Shapiro says. "But I keep waiting for the other shoe to drop. At some point the national office is going to call and say, 'We are going to make project-by-project decisions,' and we'll see where that ends up."

At today's price-to-book multiple of 0.96, Lennar is the cheapest since 2011, though a recession, if it materializes, would surely dent the balance sheet. Somewhat attenuating that risk is the fact that U.S. housing prices are not in a bubble and that Lennar has taken to controlling its inventory of vacant land through the purchase of options, rather than by buying it outright for cash. Thus, in the fiscal year ended Nov. 30, 2019, a third of the land was option-financed, up from a quarter the year before.

Lennar's 20.5% gross margins likewise afford a margin of safety. Subtract the 6% of revenues that selling, general and administrative expenses absorb, and you realize that home prices in Lennar's communities would have to fall by more than 15% before management would start taking write-downs. "We think impairments would require a go-forward estimate of sharply declining margins and prices beyond the next quarter or two (and home prices seem actually inelastic in this environment), and LEN's shorter land duration limits the [discounted cash-flow] calculation impact even if we were to reach that point," according to a team of Barclays Capital, Inc. analysts led by Matthew Bouley.

As of Feb. 29, Lennar showed a ratio of debt to total capital of 33.6%. There was $785 million of cash on hand and $2.1 billion available in a revolving-credit facility. Maturities appear reasonable, with $600 million's worth of debt coming due in 2020.

"They're very nimble," says Palacios. "They're very forward-looking. Stuart Miller has used the line, 'We're a tech company that builds homes.' And that you couldn't have been in a better position strategically in terms of those initiatives over the last few years, than where Lennar is now." These investments, which include stakes in tech upstarts like OpenDoor, allow Lennar to use virtual showrooms to display homes to prospective buyers and close transactions entirely digitally.

With 14 buys, five holds and no sells, the Street is well disposed to Lennar. Despite the wild price swings, short interest foots to only 4.9% of the float. Year-to-date, insiders have sold 355,693 shares for net proceeds of $23.6 million at an average price of $66.40, or 73.8% above the current price.

Attention, insiders: This analysis is for you, too.

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