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Real Estate Watch

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Economic Analysis

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What do analysts think of housing construction companies?

- **Homebuilders took a hard hit in the stock market during 2011, with their share prices falling by more than 50%**
- **Fundamentals however, suggest the price fall might have been excessive**
- **Arguably, the outlook for construction industry in 2012 is better than that of 2011, which will probably help homebuilders in lifting their share prices**

For the housing construction companies in the stock market, 2011 was a difficult year, being that while sales volumes and revenues grew, in some cases at double-digit rates, the price of their shares contracted by more than 50%. In addition, this behavior strongly contrasts with the price index and the stock market quotations which, even though with ample volatility, remained at the closing at levels similar to those seen the previous year. In this Mexico Real Estate Watch, we seek answers to this divergent behavior, consulting the stock market analysts who follow the sector.

The results of the study[1] clearly reflect the priorities of investors, who simply and plainly seek profitability in a changing environment which demands continuous valuation of their expectations. There are periods, as the current one could be, where companies' decisions privilege medium-term investment decisions to the generation of yields or cash flows in the short term. This, which has been the position in some cases, has been taken into account by analysts; the same as the strategies that housing developers have adopted in what is perceived as a new housing model in the coming years.

Although it is recognized that the punishment of share prices is generalized and does not necessarily incorporate (although it could and should) the differentiation in the business models, it is also true that the weakness in the yields is not a new story, but has instead been a constant in recent years. Nevertheless, it is recognized that the housing market will continue to show important dynamism going forward and publicly traded companies are well-positioned for capitalizing on the opportunities that will be generated.

The market has strongly punished the construction companies

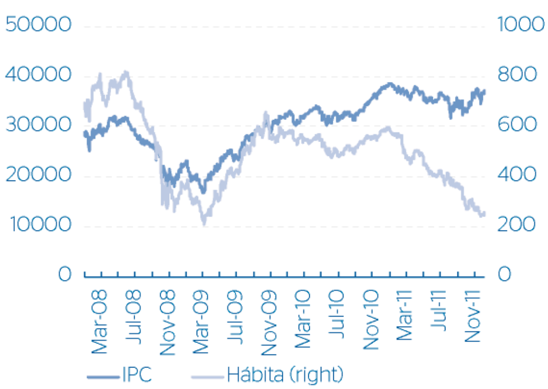
The value of the shares of housing construction companies contracted by close to 50% during 2011. The Hábita Index, which concentrates the sector companies, went from a value of 595 points at the end of 2010 to 256 points in December 2011,[2] that is, a contraction of 57%. In the same period, the Mexican Stock Exchange Index fell from 38,550 to 37,071 points, also a drop, although much more modest (3.8%).

However, by expanding the comparison horizon a little, it can be seen that the Habitá Index has maintained a negative trend as of the second half of 2008; its value at the end of 2011 came to barely 30%. compared to the highest level it reached in that year.

Moreover, the drop is generalized and what is interesting is that it has occurred despite the increase in revenues which, except for 2009, have shown double-digit rates among some of the issuers. In 2011, (with figures through the third quarter), revenues continued to rise (save for two issuers that reported negative figures in the third quarter). Although it is clear, the increase in revenues is not what is most important and clearly it has not been the determining factor in the share prices.

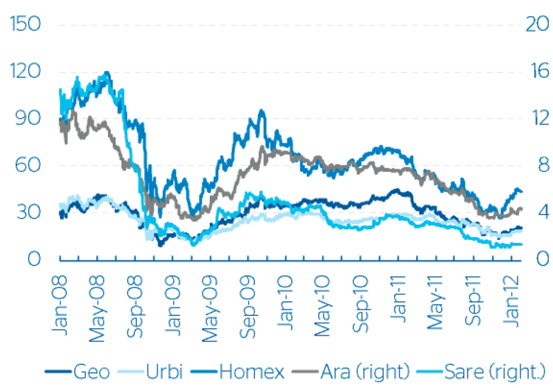
[1] The analysts of Actinver, Banorte, BBVA Bancomer, Credit Suisse, Deutsche Bank, GBM, JP Morgan, Morgan Stanley and Scotia Capital participated in this study.
[2] Figures to December 6..

Graph 1
Stock market indexes: IPC vs. Hábita
(points)



Source: BBVA Research with Bloomberg data

Graph 2
Stock market indexes: housing construction companies
(pesos per share)



Source: BBVA Research with Bloomberg data

The source of the discord appears to be in the profitability indicators, particularly in the generation of free cash flow (FCF), which has been showing consistently negative figures since 2007. Moreover, also causing discontent among analysts, has been the fact that for 2011, according to financial guides provided by the issuers, said indicator would show positive figures or at least less negative ones,as occurred in most of the cases.

Chart 1
Construction companies: Revenues
(Annual % nominal change)

	Geo	Urbi	Homex	Ara	Sare
2007	19.4	27.1	29.0	9.3	19.4
2008	16.5	17.4	16.6	-3.7	-5.6
2009	10.1	-13.0	-7.3	-20.2	-40.2
2010	-0.3	14.5	12.5	3.6	-17.1
1Q11	19.7	17.1	14.1	3.5	2.4
2Q11	3.9	15.5	13.7	4.1	2.0
3Q11	9.3	8.0	10.3	-19.6	-43.2

Source: BBVA Research with Bloomberg data

Chart 2
Construction companies: FCF*
(Millions of pesos)

	Geo	Urbi	Homex	Ara	Sare
2007	-2179	-2441	-93	-622	-671
2008	-366	-1660	-3795	-894	-563
2009	748	2723	449	780	-4
2010	-616	355	-1380	-317	534
1Q11	-290	-806	-290	-544	-14
2Q11	-480	-169	918	-247	207
3Q11	-865	-1000	-246	132	----

*Free cash flow Source:
BBVA Research with Bloomberg data

The consultation of the sector analysts, directly or through reports, allows confirming that the generation of FCF is key in its valuation of the performance of the issuers. However, it also influences the diagnosis of the strategies adopted individually to guarantee growth and long-term profitability. The following is a synthesis of are the main findings, some of which are quite interesting with regard to the consultation realized.

What do analysts think about the housing market?

The change in the construction model, of horizontal to vertical housing, has forced making new investments in land and, in general, to increase the working capital requirements. In this process, where the public construction companies are seeking to accelerate the pace to position themselves solidly in the 2012 subsidy program (that will advance the distribution of resources, mainly in the first quarter), the generation of FCF has been delayed, and no substantial changes are anticipated prior to the second half of 2012. It should be specified that the FCF is one of the most important variables for analysts at the time they are estimating the target prices of shares, as well as the operating margin (EBITDA).

However, as some have pointed out, there are some elements that could help to mitigate the increase in working capita requirements, such as the reduction of up to 30% in construction costs in the vertical model vs. the horizontal (due to lower expenditures in urbanization and more houses per hectare).

In general, there are doubts regarding the current value of the land reserves of the construction companies. Some feel that they would have to be sold at a discount, because the new housing model requires better located land. In any case, there is ignorance as to their location, the degree of urbanization as well as its valuation. Also, the adoption, as of 2012, of more unified standards at an international level in real estate accounting (IFRS) generates uncertainty regarding the manner in which reserves should be valued and accounted.

On the other hand, the analysts consider that the change in model toward vertical housing tends to benefit the publicly traded companies, at least in the short term, being that the smaller ones lack experience and technical capacity in these projects. According to some analysts, by reading this, the companies could moderate the investment rate so as to achieve a greater generation of FCF.

The reforms to the Infonavit Law, the same as with the programs that will be launched for the unaffiliated population in public housing institutions, are perceived as potentially important for boosting the market, to the point of even doubling it, according to some, although there are those who also think that with the reform of the Infonavit Law, the incentive for acquiring a second home will be lost to monetize the balance of the housing sub-account.[3] For others, these programs will serve at least to maintain the dynamism of activity. And, the thing is that there are those who maintain the idea that the base of Infonavit-affiliated workerswill be reduced importantly as of 2016.[4]

Analysts believe that the recent situation, where the financing of housing construction has shown a certain restriction, the publicly traded construction companies are better positioned than their competitors, both due to the capacity to access various financing sources, such as the high share that they have in the loans granted by the public housing institutions. This last fact would also be an important advantage in a scenario of a slowdown in economic activity.

…on housing construction companies?

Geo

It is well-positioned in the new housing model with technology that allows for accelerated construction and well-defined commercial strategies. It has the highest share in the Infonavit among the construction companies, and it is positioned in the lowest income segment, which is the highest beneficiary of the subsidy programs. More than half of its sales are concentrated in homes of less than P$300,000, which, due to the advantage of having the subsidies, are those that move more quickly. It has an association with specialized investment funds for the administration of its land reserves, which generates a certain pressure on net income. Some perceive their indebtedness levels (relatively high) as an element to watch, particularly in a scenario of an eventual economic and/or financial restriction.

Urbi

It is well-positioned to attend the unaffiliated population, given that, for some time, it has developed a commercial strategy for attending this segment (savings and rental programs with an option for purchase). It has ample reserves (the most important in terms of value) that it expects to place with higher margins than those of housing. The company has opted for long-term growth prior to generating free cash flow. It has a solid balance with high EBITDA margins, low leverage and accelerated inventory turnover. It also has generalized optimism as to the success of its strategy in the medium term.

Homex

It is focused on an income segment slightly higher than Geo and Urbi. It has a shorter working capital cycle. It has made important investments in land reserves, as well as in entering new markets (Brazil) and businesses (penitentiaries). At least in the short term, this implies important working capital requirements, which implies a delay in the generation of free cash flow. The diversification in its businesses has generated some surprise (and uncertainty), even though there is confidence in the success of the operations in a medium-term horizon.

[3] In principle, this would seem to have a negative impact on the market, but, in reality, this is not the case. A good part of the uninhabited homes has to do with this "incentive". With the passing of time, what was confirmed is that in a good number of cases, the second home did not cover a household need and there were not many possibilities for renting or selling it.
[4] Although this, in reality, was not what the Institute wanted to transmit, but rather that it had to be developing differentiated products to integrally attend its affiliates' needs. It should also be noted, and it is not a lesser topic, that the estimates were done by using the figures of the 2006 count, being that the 2010 census showed a very different dynamic of population and household formation.

Ara

Growth has remained stable in recent years (at low rates) and there is an surplus of available land. In relative terms, it is lagging compared to the other construction companies. There are some doubts reagarding its capacity to position itself quickly in vertical housing projects for the low-income segment. The generalized perception is that its balance is solid and, should the financial results of the company improve (begin to generate free cash flow), the potential increase in the price of the company's shares would be significant. The performance that it will have in the company's most important development currently, Crystal Lagoons, will be a key factor in these results.

Sare

The restructuring process based on selling land to unleverage itself is in progress. The strategy could be the appropriate one although the more restrictive economic conditions could force the company to apply significant discounts to its land reserves. The company has had difficulties in moving its homes in the medium and residential segments, and has found financial restrictions for funding the required working capital in projects for the medium- and low-income segments that move more quickly. The company should be resolving its leverage levels, at the same time that it finds sources of liquidity that will allow it to expand its operation and improve its execution capacity.

Chart 3
What do the analysts think of …?

Geo	• Solid positioning in the low-income segment • It has the highest share in the loans granted by the Infonavit (90%) • A construction model adapted to the new model: vertical and sustainable
Urbi	• Well-positioned in the **non-affiliated** segment (Urbi Alternative) • With a possibility for marketing reserves with high margins • A long-term growth strategy
Homex	• It diversifies its operations with new markets and businesses • It still requires investment in working capital to consolidate projects in progress • Its strategy **offers** promissory results, although not in the short term
Ara	• Stable growth in recent years • Solid balance with a low indebtedness level • Crystal Lagoons Development, key to the strategy of the business
Sare	• Liquidity restrictions inhibit greater growth • Sale of territorial reserve, strategy for lowering indebtedness • Important to include in its sales mix a greater share in the low-income segment

Source: BBVA Research

Conclusions

In a year of growth in revenues and sales, the housing construction companies have been strongly hit in the stock market. Investors are clear in that the most tangible result of the solid performance of a company is the generation of cash flow. The decisions that the companies make must have, in time, a mix of sustainability and growth with profitability.

Thus, there is consensus among the analysts in the sense that the punishment to the share prices has to do fundamentally with the absence of FCF, but that in most of the cases, this is a situational condition associated with the increase in investment. In the long term, the sector continues to be structurally strong. As for the current evaluations, analysts coincide in that for the companies with the best balances and/or the most solid positioning going forward, the rallying margin that the prices of their shares would appear quite attractive. It would seem, then, that the question is not whether the shares should rally, but when.

Having said this, and if conditions seem to be favorable for a better financial performance of the construction companies in 2012 (with the program for the unaffiliated, together the advance in the calendar of delivery of resources) everything at the end will depend on the speed in which the companies themselves will advance in the vertical projects and to the degree in which the housing support programs of the federal government materialize successfully.