CAPCO
ASSET MANAGEMENT

The following is an excerpt from our letter for the 1st quarter of 2007:

On the Housing Bubble

In our second quarter 2005 letter, we discussed the real estate market and our cautious view:

> *. . . we want to sound a cautionary note on the subject of real estate as an investment. It very much appears to us to have taken on many of the characteristics of a bubble. . . When combined with aggressive lending practices and increasing reliance on very risky forms of debt, the environment has the potential for significant future problems. Caveat emptor.*

Because the largest worry weighing on stocks these days is related to housing and the mortgage market, we thought this an opportune time to revisit the topic. In this letter, we discuss the expansion of easy credit, the danger of relying on "liquidity" in a market, the impact this had on the homebuilding industry and our thoughts on investment in this area.

A major driver of the recent housing boom was the existence of easy credit. Housing has long been excellent collateral, and that record led lenders to be increasingly relaxed about the terms on which they lent. Housing loans were pooled and packaged into bonds, and bond investors provided an extremely willing market; so willing that the intermediate lenders repeatedly lowered their lending standards, in order to create more supply to meet the demand. Combined with historically low interest rates, the result was a generous lending environment for anyone willing to use the money to buy a home. As a result, home prices (and to a lesser degree, new home volume) soared.

That state of affairs couldn't go on indefinitely, and it didn't. Substantial frauds by borrowers have come to light, loan delinquencies are up and foreclosures are rising. Underwriting standards for weak credit records have been tightened, a belated move for a category that made up a third of 2006 mortgage issuance. Many of those who provided capital to weak credits have suddenly withdrawn their willingness to do so, so that loans are no longer available on the same terms, at the same rates, and in the same quantities, as they recently were. Many major sub-prime lenders, who only weeks ago were doing multi-billion dollar volumes, are now defunct. These lenders were capitalized on the assumption that the market for sub-prime lenders would continue to have ample liquidity; when that premise ceased to be true, their ability to operate likewise ceased. In short, the sub-prime lending market is in a state of collapse. While there has not been a corresponding meltdown in the mortgage market for prime credit quality, there are plenty of similarities, in terms of looser standards, rising delinquencies and blind reliance on credit scores.

The mortgage debacle highlights a recurring theme in investments, the role that "liquidity" plays in influencing asset prices. Liquidity refers to the ability of a market to match supply and demand without a dramatic change in price. In times of high prices, bullish commentators will frequently focus on the existence, at that particular moment, of abundant liquidity, arguing that this will sustain prices (ironically, of course, the rising prices may suggest an excess of demand, not price stability). But liquidity is more a state of mind than of economics, and there is a significant danger in relying on it to support an investment case. As the history of numerous bubbles demonstrates, liquidity is a fragile state of mind, and it can change in an instant. That is what has just happened to the sub-prime mortgage lenders and to a lesser degree to homebuilders.

The existence of easy credit swelled demand from marginal buyers and speculators. The large public homebuilders have argued for some years that "this time was different," that they would not fall prey to the cyclical excesses that have plagued the industry in the past. While that hypothesis is now being put to the test, we don't find much supporting evidence for their claim. By our analysis, virtually every public builder ramped up capacity to meet a level of demand that was not sustainable; in short, this time was ***not*** different. Many of them showed explosive investment activity right into the early part of 2006. For some, that has continued right into the first quarter of 2007. Their investment activity includes making very substantial direct investments in land, and to some degree building ahead of demand. But they also took on less visible commitments that force them to write off large investments, make large payments, and/or continue building despite falling demand. These less visible commitments include firm schedules of future land purchases, guarantees of development infrastructure completion, and guarantees of debt for off-balance sheet entities.

Generally, the public builders characterize their controlled land positions as "options", implying the ability to walk away from their deposits without further commitments. And to be sure, they have collectively already walked away from hundreds of millions of dollars in option deposits. By one company's estimate, these and future cancellations will put $10 to $20 billion of land back onto the market. At the same time, however, they continue to buy more land and build more homes, suggesting that some of their "options" are more constrained than the word implies. This view is reinforced by the fact that many of the public builders operate with large and poorly disclosed "off balance sheet" commitments.

When combined with significant levels of debt and restrictive debt covenants, some of the public builders are under enormous pressure to turn their land and development exposure into cash. They have large "sunk costs", so pricing may be driven more by the desire to recover capital and shore up their balance sheets than to report profitability. As a result, public builders are cutting prices and using incentives, with reductions of 15% currently common.

The public builders are lowering prices aggressively for another reason as well. New homes are only about 20% of home sales – the vast majority of sales are actually existing homes, which are mostly owned by individuals. These homes are sitting on the market longer and listing prices are falling, but there has not been dramatic movement in their prices to a level that will clear the market. So the public builders are in a race to build and sell homes to recoup cash and reduce their development liabilities before prices fall on existing homes.

Going back a number of decades and through multiple housing cycles, the peaks and valleys of the homebuilding business are similar – remarkably so, given that the population has both grown and migrated during this period. Housing starts have historically reached peaks of roughly 2 million homes started per year and have bottomed at 1 million homes started per year. While not necessarily predictive, these peak to peak cycles have lasted eight or more years. In 2005, the most recent peak, just over 2 million homes were started. Today, now in the second year of this slowdown, the last government report showed annualized starts down about 30%, to 1.5 million. More recent data from the public builders suggests starts are now down 30% to 40%.

This is not to say that building activity will completely dry up. Even if volumes fall below historic low points, that is still a lot of homes to build. Properly financed companies, paying reduced market prices for land, labor and materials will meet this demand.

That will take some adjustments, throughout the industry. There are two ways to look at the 15% price cuts: the direct impact on the builder's profit as a 15% selling price reduction gets applied to the sunk construction cost, or the eventual impact on the entire supply chain as it adjusts to new lower end prices. In the first (and currently observable) case, the builder selling a recently finished home at a reduced price is seeing a 60% profit reduction. In the second case (looking forward), builders seeking reasonable margins are demanding concessions from all their inputs: land, labor and materials. If a builder is to achieve a reasonable margin, we estimate that today's 15% price cuts translate into a 30% reduction in the land value, and in some cases, that is the reduction that some builders are now seeking from land sellers. Where an adequate price reduction cannot be agreed upon, builders are walking away from deposits where they can. Among materials prices, lumber prices have fallen some 40%, wallboard is starting to decline, but concrete and some other inputs have not fallen yet. The bottom line is that virtually all the inputs are, or will be, adjusting to reflect falling demand; where once there was a limited supply of many inputs, there now is excess capacity in most of them.

At some point however, the population fundamentals will work their way through the excess inventory, and starts will rise again. We have plenty of interest in participating in that recovery. As always, our participation will be on the basis of the right combination of business, people and price. We have a pretty good short list of candidates, primarily suppliers, but at least one builder is intriguing.

We have no prediction about how long it will take or how much prices will fall, but we lean towards thinking this will be a long slow grind, not unlike the three years it took the Nasdaq to decline 80% from its peak. The difference between housing today and the technology bubble is that the valuations of technology companies (and the market broadly, for that matter) were stretched to absurd levels. However, we do not think the valuations for homebuilders and related industries are now stretched to anything like the degree we saw in the technology bubble. What did become stretched were the valuations of the land itself, so the investments we are looking at are not based on current land valuations.

The exposure of our current portfolio to the aftermath of the housing bubble is minimal. Our cash is invested to avoid capital risk, so it has never been exposed to mortgage credit. For some time, we have had a short position in some heavily leveraged builders. Our portfolio companies will certainly be hurt by a general economic slowdown, if one emerges, but we have only modest direct exposure to housing. Only one portfolio company has meaningful exposure, a materials supplier in which we recently took a small position, and we made that investment with the perspective we articulated above.