

Builders Grounded by Land Prices

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By JOHN JANNARONE

Glimmers of a home-price recovery mean that some home builders may soon return to the black. But, with prime land plots tough to find, investors shouldn't set their sights on healthy profit margins.

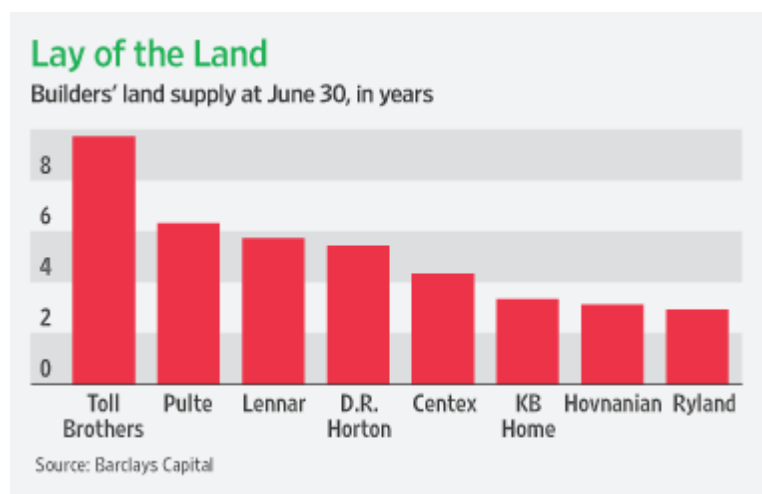
Over the past few years, many builders have shed some of their best land holdings and hoarded cash to strengthen balance sheets. Many expected to be able to restock at low prices when competitors fold, conscious that the last big property bust in the early 1990s led to plenty of cheap land sales.

It hasn't yet worked out that way. Even with many private builders going bankrupt, the supply of desirable lots has run dry.

That's partly because many lenders who have taken possession of land are wary of selling while the market is soft. So land costs are rising in locations where builders are most keen to invest.

Take California, where the likes of D.R. Horton and KB Home have a sizable presence. In prime locations, prices of finished lots have risen 10% to 30% in the last four months, according to **Jeff Spindler of land brokerage Park Place Land Advisors**.

Publicly listed builders have accounted for the majority of bidders at auctions of such finished lots, **Mr. Spindler** says. While land prices in remote areas have been more stable, major builders have been focused on densely populated areas where homes are expected to sell quickly.



The risk is that builders are betting on higher housing prices to justify paying up for land. But if home prices don't keep pace, builders could see margin growth stifled. Citigroup's Josh Levin says the median gross margin for public builders is around 13%, compared with roughly 20% before the bubble.

Builders with the least land could be expected to buy most aggressively. KB Home, for instance, has land sufficient for only 3.3 years worth of building needs based on construction rates over the past year, according to Barclays Capital's Megan McGrath. That compares with an industry average of about 5.1 years.

And those estimates could exaggerate the true supply, since they include both finished lots and raw land. The latter requires thousands of dollars in additional investment per lot, so it's unlikely to be used until home prices increase substantially.

Horton may also feel pressure to refill its land bank. The company still has 5.4 years of supply, but the number of

owned lots has fallen 32% in the year through June, Ms. McGrath estimates.

And yet, stock valuations suggest hopes for a smooth return to profitability. Ms. McGrath says Horton trades at 1.5 times tangible book value, while KB Home is at 1.9 times.

Those are roughly in-line with the industry's long-term average of 1.6 times. But that long-term average mostly reflects years when retained earnings were causing book values to grow.

With major builders still bleeding red, their stocks are dependent on a swift home-price rebound.

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