

93/10-Investing on the House

By Peter Lynch

There's been a lot of sobering talk lately about housing and how instead of getting a big bounce in housing starts, we're only getting a hop. The "disappointing" housing numbers are used as evidence that the economic recovery has stalled.

I've been hearing a different story from David Berson and Mark Obrinsky, two of the resident experts at the Federal National Mortgage Association (Fannie Mae). While it's true that this year's estimated 1.27 million housing starts will fall far below the record of 2.4 million in 1972, Berson and Obrinsky estimate that 1.1 million single-family homes will be built in 1993. This almost reaches the all-time high of 1.2 million, set in 1986. Moreover, 3.8 million existing homes (the industry never calls them used homes) will change hands this year. This is also close to the all-time record of 4 million, set in 1978.

So we're in a strong phase for single-family construction and a boom in used-home sales, and housing in general is the most affordable it's been since the early '70s. The price of the median house continues to increase each year, as it has for the two and a half decades this data has been collected.

What hasn't bounced is multifamily housing, but that's not because we've been in a recession. The government has pulled its support for low-income housing and eliminated the tax shelters that created the boom in residential high-rises in the 1970s and early '80s. In 1972, there were 906,000 apartment buildings of five or more units built in the U.S., and last year there were only 139,000. It's this decline that makes the overall housing numbers look worse than they are.

Three years ago, I began to look into the housing sector, since housing is one of the first industries to turn around in a recovery. In the early stages, the home builders tend to do well, and home-building stocks made impressive gains from early 1991 to the end of 1992. The price of Toll Brothers, an East Coast builder that I often follow, increased more than fivefold.

Toll Brothers is a typical example of a company that will benefit from hard times. In the 1980s, anyone could build a house. All he needed was a tool kit, a nail apron, and a net to catch the money that bankers were throwing at the project. But in the bust years, banks will lend money only to established, well-capitalized builders. So builders like Toll emerge from the 1990 recession with as many new jobs as they can handle.

Nevertheless, by 1993, many of the home-building stocks had had a good run, and bargains were hard to find. The home builders may not be in the ninth inning of the recovery, but they surely have made it into the sixth or the seventh.

Whenever I research an industry, I like to call an assortment of Wall Street analysts to get their views on how various companies are doing. An analyst can be an invaluable resource, but you have to be careful about whom you listen to. I like the ones with proven records for staying up-to-date on each company they follow.

After talking to a couple of housing analysts, I found I was not alone in thinking it was hard to find bargains among the home builders. Greg Nejme at Lehman Brothers likes Lennar, a Florida builder that stands to benefit from Hurricane Andrew, and D.R. Horton, a newcomer that went public in 1992. But these are the exceptions.

From the stock picker's point of view, one of the nice things about a recovery is that it doesn't happen everywhere at once. So with the home builders already in recovery, I turned my attention to other companies in related industries that continue to struggle.

In the forestry group, John Chrysikopoulos at Goldman, Sachs likes Weyerhaeuser. Its timber sales have improved and will improve even more when Japan comes out of its recession, because Japan is a big buyer of U.S. trees. Its paper and packaging divisions are still in the doldrums, but eventually they'll prosper. Meanwhile, Weyerhaeuser has gone through the corporate Slim-Fast, selling an array of unrelated businesses to get back to solid wood.

The best thing that ever happened to timber companies such as Weyerhaeuser was the campaign to save the spotted owl. Who benefits when environmental groups successfully pressure the government to dramatically restrict the cutting of timber on federal lands? Firms with large private forests, including Weyerhaeuser, Georgia-Pacific, Louisiana-Pacific, and Plum Creek.

Plum Creek was spun off from Burlington Resources. It's a limited partnership (traded on the NYSE), and I've always been fond of publicly traded LPs. They require extra paperwork that scares a lot of investors away, and this creates bargains. Plum Creek has a decent balance sheet, strong cash flow, and no expenses to speak of. It's just a bunch of trees that the company harvests and sells, sending the proceeds to the shareholders as dividends.

The dividend fluctuates with profits, but at present the stock is yielding 7.7 percent. Since Plum Creek plants several new trees for every tree it cuts, there is an endless supply. This is a conservative's way to invest in lumber futures.

A few years ago I recommended Pier 1 Imports, on the theory that a housing revival is good news for home furnishers. Nobody wants to live in an empty house, and the new occupants have to have lamps, rugs, couches, and other such items that are sold at Pier 1.

Pier 1 has had its ups and downs, in part because the recovery in home furnishings is lagging the recovery in home sales. Perhaps home buyers have spent all their money and are holding off on decorating and renovations until they can replenish their bank accounts. But all the analysts with whom I spoke expect home furnishings and appliances to do well in 1994. Let's take a tour of the department store to find their favorite companies.

In the paint department--"coatings" on Wall Street--I heard nice things about Sherwin-Williams. This is one of those great companies in boring industries for which I'm always on the lookout. Paint is a pretty boring industry, but Sherwin-Williams has done a spectacular job, and the stock has been very exciting. The company has 2,000 outlets and opens 20 to 30 new stores each year, which is the slow-and-steady approach to growing a business. And when every U.S. town has a store, they can always move into Canada.

In the furniture department, John Baugh of Wheat, First Securities likes Heilig-Meyers, a retailer with 450 stores in 16 states. In the next five years, Heilig-Meyers plans to enter 19 more states. Their formula works, and they are taking it on the road, a la Wal-Mart. I learned from Wal-Mart and from McDonald's that successful companies can continue expanding for decades.

David Dwyer of Kidder likes Ethan Allen Interiors, the furniture maker spun out of INTERCO in 1989 that went public last March. The stock was \$18 then and \$19.50 now, so it hasn't gone far. Ethan Allen is famous for its Early American line, but half of what it makes today is contemporary. It earned \$1.08 per share in the year ending in June, and Dwyer expects \$1.45 next year and \$1.75 by 1995.

I also got positive reviews on Pulaski Furniture, Winston Furniture (which went public at \$16, then dropped to \$10.50), Pier 1 (a stock I still like), and Leggett & Platt. L&P; is one of those wonderfully boring companies that makes a product that puts people to sleep: bedsprings. It has 50 percent of the bedspring market and is a major supplier of recliner parts for easy chairs and hide-a-beds. It has a great balance sheet and excellent earnings growth.

In the appliance department, Bob Cornell at Lehman Brothers likes Whirlpool, which makes 50 percent of the washer-dryers and 25 percent of the refrigerators in the U.S. This was a marginal company in the 1970s that has become a global leader in white goods. White goods is the industry term for large appliances; small appliances (TVs, microwaves, VCRs, radios, etc.) are known as brown goods.

In the carpet department, I discovered that while new carpets are superior to old ones (they are stain resistant and last longer), the price has stayed the same for many years. So carpeting is one area where the consumer is getting more for less, as opposed to, say, cars, where the prices are 80 percent higher than they were ten years ago.

Between laying down carpets in new buildings and replacing old carpets in old buildings (70 percent of the business is replacement), there's a steady demand for carpets. This should increase, because big fiber makers such as Dupont, Monsanto, and Allied are beginning to spend tens of millions to advertise the wonders of modern carpeting. Moreover, carpet making has become a highly mechanized industry in which the labor cost is only 10 percent of the price of the final product, so there is no threat of domestic carpet makers being undercut by foreign companies paying their workers 50 cents an hour.

Shaw Industries has been one of the all-time great stocks in history, number eight on the list of winners from the NYSE over the last decade. A \$1,000 investment in Shaw in 1971 is worth \$80,000 today. Shaw has succeeded by being a low-cost operator and by gobbling up many of its less efficient rivals. Today, Shaw makes 35 percent of all the carpets in the U.S., a remarkable figure. If they keep acquiring more competitors, Shaw will be making so many carpets that it may get a call from the antitrust division of the Justice Department, which probably has a Shaw carpet on its floor.

Shaw could continue to do well, but John Baugh of Wheat, First prefers <wam-co NASD:MOHK>Mohawk. Its stock price has more than doubled since Mohawk came public at \$15. Citicorp owns a big chunk from the initial offering and hasn't sold a single share, which means that Citicorp must have a high opinion of Mohawk and its future prospects. Mohawk adopted the Shaw formula, but with only 7 percent of the market it has a lot more room to expand and acquire competitors.

That's the update on the housing sector. Housing is a cyclical industry, and the situation is always fluid. Right now, the best buys seem to be in companies that make the contents for houses, but the next time the stock market has a big correction, maybe the home-building stocks will sell off, and investors will have another chance to find bargains there.

Peter Lynch writes the Investor's Edge column monthly. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is now vice-chairman of Fidelity Management and Research Co. His latest book, *Beating the Street*, is published by Simon & Schuster.;

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