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HEARD ON THE STREET

Homebuilders' Shaky Foundations

Some Companies Spend Their Cash On Own Shares as Housing Sector Cools

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Homebuilders **KB Home** and **Ryland Group** Inc. are squandering their cash on their own pricey stocks, rather than snapping up attractive land deals or saving it for a rainy day, some investors and analysts say.

Builders' stocks as a group are up 35% so far this year. Meanwhile, the torrid pace of new-home sales is threatened by rising mortgage-interest rates, and escalating land prices, a lagging indicator of the new-home market, could squeeze profit margins in some markets. Bearish investors see all this adding up to tougher times ahead.

"Cash is king when times get bad," says Barbara Allen, an analyst at Natexis Bleichroeder, a brokerage and trading company for institutional clients, in New York. "I've seen so many companies in cyclical industries buy stocks when prices were high only to regret it a year later."

She says builders should reduce debt and conserve money now that interest rates are rising and new-home sales could fall from record highs. She has been advising clients to lighten up their holdings of home-building stocks on the belief their valuations are set to contract sharply in coming months.

"I'm very skeptical when people rationalize buying these stocks at peak historic multiples in the face of substantial increases in the interest rate," adds Marco Battaglia, a portfolio manager at Thales Fund Management LLC. The New York investment firm, which both owns shares and sells them "short" -- betting on price declines -- has been active in the housing sector, but won't discuss its positions.

Last month, Los Angeles-based KB Home's board gave the go-ahead to buy back two million shares, or 4%

of those outstanding. Based on the current share price, such a purchase would cost it $115.9 million. That comes as the company has bought back nearly six million shares since 2002. KB shares are up 24% during the past 12 months, and have more than doubled since 1997, when the home-building sector began what has turned out to be an unusually long upturn.

STOCK ADD-ONS

See a chart[0] of the daily closing share price for three large building companies.

Ryland Group, of Calabasas, Calif., with 25.2 million shares outstanding and three million shares repurchased since 2002, has approval to buy back one million shares, a $66.3 million purchase based on the current stock price. Nettling some investors, the company's chief executive sold 100,000 of his shares, or 7% of the total number of shares he owns or has under option, three weeks after Ryland announced the newest share-buyback plans. Ryland shares have surged more than 66% during the past 12 months and nearly sixfold since 1997.

For both companies, the stock-buyback plans contrast with a trend in many sectors to return unneeded cash to shareholders in the form of bigger dividends, a move fueled by the dividend-tax cut signed by President Bush in May. As a rule, the homebuilders don't pay big dividends, if they pay them at all, a stinginess born of the wild ups and downs the industry faced in previous economic cycles.

Other homebuilders are doing different things with their cash. Miami-based **Lennar** Corp. has agreed to plunk down $445 million to enter a joint deal to acquire developer Newhall Land & Farming Co., which owns 36,000 acres of land north of Los Angeles. Dallas-based **Centex** Corp. has been buying land and investing in a subsidiary that sells drywall and other building products, and another that constructs schools and office structures.

To be sure, authorizations don't require a company to buy back the stock. But for their part, the companies all reject predictions that a sharp sales or market downturn looms. They say investors have been slow to reward fundamental changes in the home-building industry that have reduced volatility. For instance, companies build homes to order these days, instead of building homes first and selling them later. Builders say their stocks are cheap compared with the Standard and Poor's 500-stock index, which trades at about 28 times trailing 12-month earnings. Shares of KB and Ryland fetch 7.2 and 8.8 times trailing earnings, respectively. Historically, homebuilders haven't traded at more than 10 times trailing earnings when they are at the peak in the earnings cycle.

In a news release in mid-July announcing the board's authorization to repurchase as much as one million shares, Ryland Chief Executive R. Chad Dreier said the buybacks were an "excellent" investment opportunity. Repurchases sometimes boost stock prices because they signal to investors that management thinks the shares are a bargain. They also boost earnings per share by reducing the number of shares across which earnings are spread. Ryland shares were down $1.10 at $66.45 as of 4 p.m. Monday in New York Stock Exchange composite trading.

As for Mr. Dreier's sale of 100,000 shares, a Ryland spokesman affirmed the company's view that the stock is underpriced and said the CEO made the sales to diversify his personal investment portfolio. According to the company's proxy, Mr. Dreier owns 221,465 shares of common stock, 940,000 stock options and 235,000 shares of restricted stock.

The sales drew criticism from some money managers. "It doesn't make sense that the CEO is selling like mad when the company is buying stocks with shareholder money," says Carl Tash, the chief executive of investment firm Cliffwood Partners LLC. The Los Angeles firm sold all of its homebuilding stocks in June and has shorted shares of Ryland. Short sellers make money when stock prices fall, by selling borrowed shares and replacing them later with cheaper ones.

Mr. Tash is one of numerous investors who prefer using book value, not earnings, as a basis for determining the priciness of stocks in the home-building sector. Those who eschew the price-to-earnings comparison cite the volatility of earnings in the sector. Book value, on the other hand, closely reflects one of the sector's most important assets: land holdings, at the purchase price. As a group, homebuilders are trading at 1.68 times book value, while Ryland shares stand at 2.27 times book value, near the top of the industry. Historically, the sector drops to book value when it is coming off its cycle.

Lennar Corp. agrees that book value is a good valuation device. In a June conference call with investors, CEO Stuart Miller shrugged off the idea of acquiring a top-10 rival because "a number of homebuilders are trading at 1.5 and 2.5 times book." Lennar said later that Mr. Miller didn't mean to suggest the sector was overpriced.

Lennar's Chief Financial Officer Bruce Gross said in an interview, "The best way to generate significant returns on capital is to reinvest in our business." That is why the company agreed to buy Newhall Land in July.

Smart land purchases, however, are tougher for some companies, such as KB Home, which builds low-cost starter homes. In order to sell homes at low prices it has to buy land very cheaply. KB Home's Chief Financial Officer Dom Cecere says the company's share-buyback strategy since 2002 has paid off, noting the average repurchase price was $49. At 4 p.m. in Big Board composite trading, KB shares were down 85 cents at $57.95 each. Mr. Cecere adds that KB also has been investing in its operations, noting that it has opened more than 60 new subdivisions this year.

Further, he maintains that price-to-earnings ratio is the best valuation tool because the company "should be judged by its cash flow," and he adds that the mortgage interest rate "won't become an issue until it exceeds 9%."

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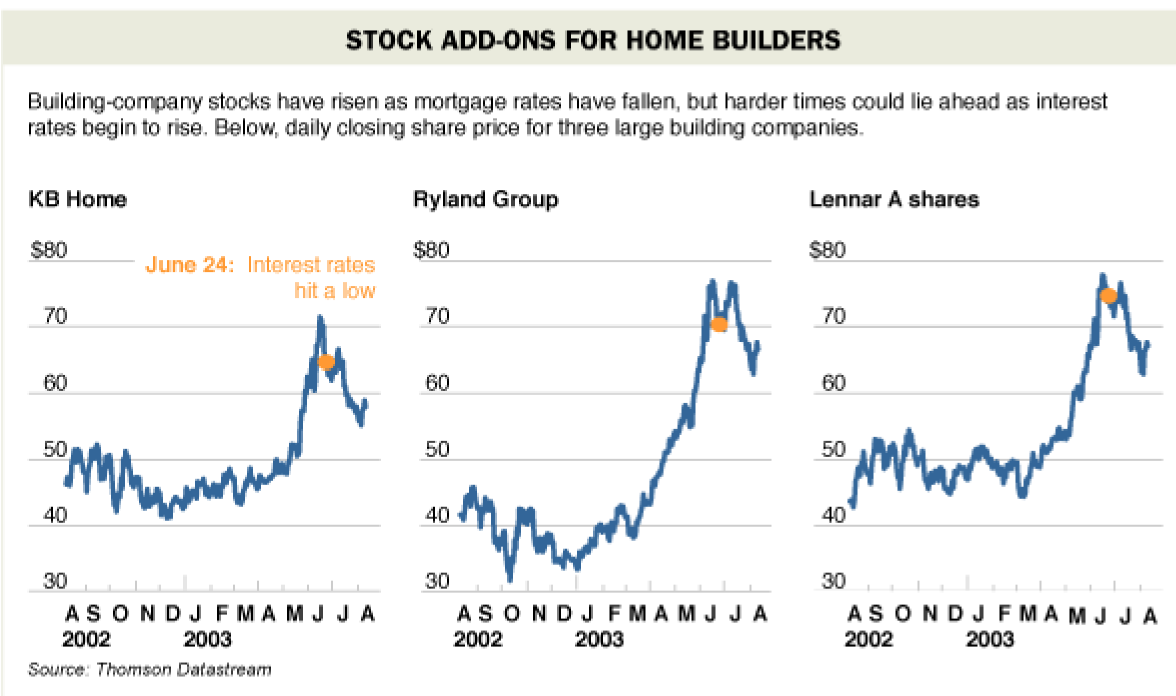

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