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## Build-a-value

Evan Lorenz writes:

Home resales in 2024 were the fewest since 1995. It's an amazing fact given that the U.S. population grew by 27% over the same three decades. Almost as striking is the decline in first-quarter home resales by 2.2%, even when measured against the paltry pace logged in the first quarter of 2024. ("Resales" are transactions involving existing homes, as distinct from new ones.)

Investment value can often be found hiding under the rock of bad news, and the building trades are beset by negative headlines. Not coincidentally, the home-builder component of the S&P 500 has lost a third of its value since October. In preview, *Grant's* is bullish on Builders FirstSource, Inc. (BLDR on the New York Stock Exchange).

The Builders story begins with the 1998 JLL Partners-led buyout of the lumber-supply business of Pulte-Group, Inc. More than 75 acquisitions followed in the next 27 years, both of lumber and lumber-product distributors, including two mega-purchases, ProBuild Holdings, Inc. in 2015 for \$1.6 billion and BMC Stock Holdings, Inc. in 2021 for \$2.7 billion.

No surprise, then, that Builders FirstSource is today one of the largest manufacturers and distributors of construction products in America, with operations in 48 out of the 50 states and in 91 out of the top-100 metropolitan statistical areas. Highly fragmented the market for building supplies may be, but the commanding share that Builders enjoys in lumber-related products in many of those MSAs provides the company with an enviable edge in ne-

gotiations with lumber mills and home builders.

Builders divides its business into four operating groups: manufactured products (23% of sales in the 12 months ended March 31), which makes factory-built alternatives to on-site framing, wood floors, roof trusses and wood panels; windows, doors and millwork (25%), which pre-assembles systems of the aforementioned products to reduce on-site installation times; specialty building products and services (25%), which spans the gamut from framing and construction work to design assistance; and lumber and lumber-sheet goods (26%). In the first quarter, 72% of products shipped were earmarked for single-family home construction, 10% for apartments and 18% for the repair and remodel markets.

The BMC deal was signed under the bluest-of-blue housing skies. At year-end 2020, the average 30-year mortgage rate stood at 2.9%, the median price of

a resold home at \$309,200. Assuming a 20% down payment, the lucky buyer faced a monthly mortgage payment of \$1,026, or just 18.3% of median household income.

Reading these happy auguries in 2021, developers began work on 1.6 million new homes and apartments, the highest pace of activity since 2006. The construction upsurge, alongside Covid-era supply-chain snafus, lifted the price of lumber to a high of \$1,670.50 per thousand board feet from an average of \$356.47 in the five years before the bug barged in. Earning as it does a margin by distributing lumber and related products, Builders reaped a double boon for the bottom line, from prices and volumes alike.

Now turn those formerly blue skies slate grey. An average 30-year mortgage rate of 6.9% and a median resale price of \$403,700 mean that the typical monthly mortgage payment sums to \$2,127 (again, assuming a 20% down pay-

### Builders FirstSource, Inc. at a glance

all figures in \$ mns except per share data

	<u>TTM*</u>	<u>2024</u>	<u>2023</u>	<u>2022</u>	<u>2021</u>
sales	\$16,166.6	\$16,400.5	\$17,097.3	\$22,726.4	\$19,893.9
operating income	1,406.1	1,595.2	2,176.3	3,770.2	2,387.4
net income	915.4	1,077.9	1,540.6	2,749.4	1,725.4
earnings per share	7.80	9.06	11.94	16.82	8.48
shares outstanding	114.3	119.0	129.0	163.5	203.5
cash	115.4	153.6	66.2	80.4	42.6
debt	4,479.5	3,704.1	3,181.1	2,984.2	2,929.8
total assets	11,447.6	10,583.1	10,499.5	10,595.2	10,714.3

\*12 months ended March 31, 2025

source: company reports

ment). So instead of spending 18.3% of median household income, today's buyer will be on the hook for 32.8% of median household income, not including property taxes, homeowners insurance, maintenance costs, etc.

The Fed's belated lifting of interest rates in 2022 simultaneously froze in place the many mortgagors who could not afford to lose, or who chose not to surrender, their sweet ZIRP-era mortgage. Accordingly, the inventory of homes listed for resale plummeted. Home shoppers who couldn't wait turned to new construction, much to the profit of home builders and their suppliers.

Now that listings are picking up again, especially in formerly hot markets like Texas and Florida (see the issue of [Grant's dated March 28](#)), the supply of existing homes marketed for resale has crept up to 4 months in March, from 3.2 months in March 2024 and 2.7 months in March 2023.

"We've just gone through and tweaked our forecasts to the downside," Rick Palacios, Jr., director of research at John Burns Research & Consulting, tells me, "so call it down five-ish percent for 2025 new-home sales.... We survey home builders across the country monthly. In May, they definitely changed their views on price. They think, net of incentives, that new-home prices will be down 1% nationally for the year. I can't remember the last time that the home builders we survey told us they thought home prices would be down."

So far, so bad: Housing starts slowed to a 1.36 million annualized pace in April, and the price of lumber has slumped to \$599 per thousand board feet. To address the affordability gap, home builders have pivoted to making smaller homes with less lumber. Builders's operating profit accordingly has been eviscerated, to \$1.4 billion in the 12 months ended March 31 from a peak of \$3.8 billion in 2022. And note, all without a recession.

Nor has the bad news necessarily exhausted itself, especially if the U.S. economy begins to contract. Even so, there are good reasons to believe that home-building won't retrace the lows it reached in 2009, when starts plummeted to 554,000, the lowest level on record in U.S. Census figures dating back to 1959. "After the Great Financial Crisis there was a flood of distressed sales that just killed new builders," Bill McBride, author of the Substack newsletter "Calculated Risk," reminds me.

In recessions that did not feature a mortgage bubble, construction declines have proven short-lived and manageable. Thus, starts fell by 15% in 1991 to 1 million units but home builders surpassed the 1990 level of activity in the following year; starts actually grew by 2.2% to 1.6 million in the 2001 recession after having slipped by 4.4% in the year it began. Even in the double-dip recession of 1980–82, when mortgage rates climbed beyond the single digits, starts did not dip below the 1 million mark.

The stunted rate of building activity in the decade following the 2007–09 recession has left the United States with a deficit of housing relative to population growth. Freddie Mac estimates that the national shortage amounts to 3.7 million units while Palacios pegs the figure at 1.2 million.

"If you take a step back, there is a ton of pent up demand," Andrew Dubill, a principal in the residential land buyer and developer Avanti Properties Group, tells me. "Over time, that's going to be the driving force for housing to return to some measure of strength. If you talk to most builders, if they are looking at 2026 or 2027, they feel pretty good because of this pent-up demand, but the near term is very choppy."

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The bull case for Builders begins with capital allocation. The BMC merger in 2021 was an all-stock transaction that raised the Builders share count to 206.4 million from 116.8 million. Since the deal closed, management has spent \$8 billion, or 63% of the current market capitalization, buying back stock and reducing the share count to 110.5 million.

Valuation contributes its mite to the bullish narrative, too. Down 43% since September, BLDR trades at 13.1 times trailing earnings per share and 11.8 times the guesstimate for next year's EPS. These are submarket multiples on depressed earnings.

On May 8 and 9, the man who knows Builders best gave the stock a ringing endorsement: Chairman Paul Levy spent \$55.5 million buying 500,000 shares, bringing his total holdings in the company to 1.7 million shares. A former managing director at Drexel Burnham Lambert, Levy was one of the cofounders of JLL Partners (he is the final "L" in the firm's name) and has served on the board of Builders since it first met 27 years ago.

"Since 1998 he's nurtured Builders FirstSource into the business it is today," Robert Robotti, the eponym of Robotti & Co., Inc. and a shareholder in Builders, tells me. "He's been phenomenally successful. Paul was the critical guy in guiding the countercyclical buy of ProBuild, then consolidating with BMC. Now, in recent years, he guided the aggressive repurchase of stock at what he believes is below what the business is worth."

Surprisingly, Liberation Day was a non-event for the construction sector. When President Donald Trump set Chinese tariffs at 145%, "we ran the math, and it ended up being about a 2% increase in the price of a new home," says Palacios. Still less formidable is the currently targeted impost of 30%.

Trump's plans to deport illegal immigrants, including the many who work in construction, might seem to present a very real threat to Builders. In fact, the company's manufactured products and windows, doors and millwork divisions, which deliver 49% of trailing sales, may shine. These are the business units that assemble housing components in a factory setting. The system delivers higher-quality and faster building with less onsite labor.

Builders does not disclose the profitability of its business units, but it does tell me that its value-added products have margins more than 1,000 basis points higher than those on commodity lumber. "I think the trend is for value-added products ultimately being the business, period," CEO Peter Jackson tells me. "We'll always sell dimensional lumber. It's an important part of any home that's constructed. But the reality is that the skilled trades are not as prevalent as they were 10 or 20 or 30 years ago. The ability and the skillset required to build a high-quality home need to be buttressed with off-site expertise."

Even so, for all its manufacturing prowess, Builders is primarily a distributor, and a good thing it is from an investor's perspective. "The reason why these businesses are attractive is because they are capital-lite and there is a countercyclical nature to them, as they can sell down inventory when things slow down," Adam Schwartz, the CIO of Black Bear Value Partners, which holds a position in Builders, tells me. This allows distributors to generate positive free cash flow during industry downturns. In Builders's case, between

year-end 2021 and March 31, 2025, inventory declined by \$277.3 million while accounts receivable shrank by \$457.2 million. Combined, two adjustments have delivered a \$734.6 million uplift in cash flows.

As of March 31, the Builders balance sheet showed a net debt balance of \$4.4 billion, or two times trailing Ebitda, at the top end of management's target leverage range of one to two times. The company is rated Ba2/double-B-minus, i.e., the upper echelons of junk.

Despite that moderate dollop of debt,

according to the front office, Builders has sufficient financial firepower to generate \$1 billion in free cash flow in 2025, and the company is already spending to reduce the share count. Management laid out \$403.3 million for share repurchases in the first four months of the year and the board of directors approved a new \$500 million share-repurchase authorization on April 30. The equity market cap stands at \$12.7 billion.

Of the 21 analysts who follow the stock, 14 say buy and none says sell. Short interest as a percentage of the

equity float has risen to 4% from 1.9% at the end of November. Over the past 12 months, insiders have purchased a net 425,118 shares at a net outlay of \$43.7 million.

Despite the weak housing market, Builders FirstSource is priced to deliver an 8% free-cash-flow yield based on 2025 guidance. When the market recovers, as on form it will, that yield will likely jump into the double digits. And while we wait for the rebound, the company will keep buying its own stock.

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