

Thinking Small to Play the Big Opportunity in U.S. Housing

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When investors think about housing stocks, they usually conjure up established large cap names like Home Depot, Lowe's, D.R. Horton or Lennar. It makes sense, given the massive size of the U.S. housing market, that investors see these huge names and others like them as the only way to get exposure to such a massive market.

But there are also opportunities in small cap stocks to gain exposure to a U.S. market that is still poised to grow. The U.S. housing market can buy stocks of markedly different market capitalizations as well as those of a surprisingly diverse array of ancillary businesses. When it comes to the U.S. housing market, there are small cap opportunities that are worth examining as investors decide on the best way to gain exposure to the largest housing market in the world.

To start with, we see the U.S. housing market as attractive for three main reasons:

1

Mortgage rates remain low, which is of course a favorable factor in making a housing purchase affordable. Every basis point here matters greatly as far as the number of potential buyers. For example, in 2019, the reduction in mortgage rates from a national average of ~5% to 3.75% made housing affordable for an estimated 6 million more households (a 15% incremental increase). We believe that for the time being, considerable rate hikes are unlikely.

2

Demographics remain advantageous. More and more millennials are moving to entry-level houses, and this growth should continue to play out for many years. In 2022, the largest age cohort within the millennial generation will reach their prime home-buying years.

3

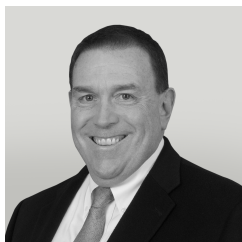
Home-building has declined in the last decade. Based on either household formations or housing vacancy rates, it is estimated that current single-family production is running 20% to 25% below structural demand. This is due in large part to labor shortages, land constraints and reduction of real estate developers. The land constraints and lower inventories should be particularly constructive to the U.S. housing market moving forward.

What small cap stocks are well-positioned to grow against this backdrop?

For one, Installed Building Products (IBP), an installation contractor with a \$2.3 billion market cap, continues to see accelerating incremental margins, which have led to upside earnings surprises. The company, which installs garage doors, bathroom fixtures, fireplaces and doors to name a few of their services, is not dirt cheap, but represents real growth with a clear path to growing incremental margins from 8% to 10%, to 15% or better. The company has excellent management and is the purest “housing play” we will cover.

Universal Forest Products or UFPI, with a market cap of approximately \$2.2 billion, engineers, manufactures, treats and distributes lumber to lumberyards and other wholesalers. At 16 times earnings, the stock is a good value, and is well-positioned to grow their topline earnings over time. In fact, the well-run company has doubled earnings over the last five years and maintains great growth characteristics for the foreseeable future.

Lastly, an underappreciated stock we see as being a tangential play to housing is KNOLL, which manufactures furniture for both the office and home. Over the last five to 10 years, the company has been diversifying away from office furniture and toward lifestyle (home) and “resi-mercial” products. While only 40% of revenue is derived from the lifestyle business, the company is well-positioned to continue to grow their “resi-mercial” and lifestyle lines and is even dipping their toe into e-commerce. It is seeing high single-digit sales growth, and we expect this to continue in the future.



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