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New ZIRP code

Evan Lorenz writes:

Curiously, the housing market is sagging even as the economy is growing. Affordability, an entry-level construction drought, post-crisis regulation and the legacy of zero-percent interest rates are among the culprits. Now unfolding is a survey of the sprawling allied businesses of house-building and mortgage-making. We're bullish on them for the long run, guarded for the short run and bearish—still—on *Grant's* pick-not-to-click Ellie Mae, Inc. (ELLI on the Big Board; see the issue dated April 6).

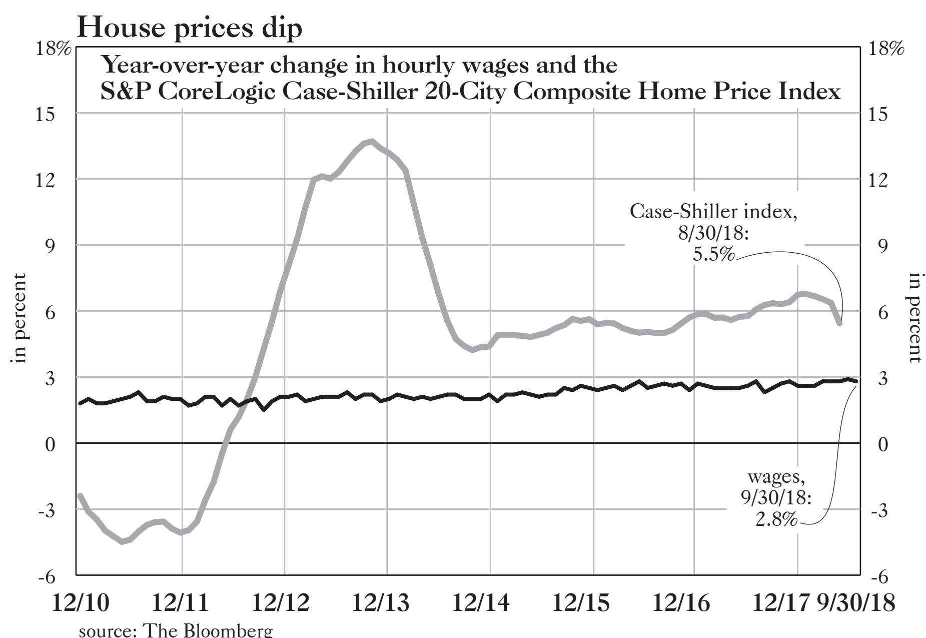
First, credit where credit is due: EZ money policy has certainly lifted asset prices. From year-end 2012 through August 2018, house prices, as measured by the S&P CoreLogic Case-Shiller 20-City Composite Home Price Index, have compounded at an annual rate of 6.9%. The Fed has been slightly less successful at lifting hourly wages—they have compounded at an annual rate of 2.4%. In consequence, the proportion of survey respondents who tell the University of Michigan that now is a good time to buy a house declined to 64% in August from a post-crisis peak of 83% in December 2014.

You'd expect that rising residential real estate would energize the home builders, but the macro data don't show it. Over the past five years, nationwide starts averaged an annual 1.1 million (both single- and multi-family), well below the 1.6 million or so growth rate in new households. "There is a gap there, and it is significant and has persisted for a number of years," says Andrew Dubill, senior vice president of investments at Avanti Properties Group, investors in raw land suitable for residential development at some future date (*Grant's*, May 29, 2015). "We believe we have an accumulation of three million underbuilt homes across the country."

The starter segment is the one that's neglected. The five top home-builders by market cap—DR Horton, Inc., Lennar Corp., NVR, Inc., PulteGroup, Inc. and Toll Brothers, Inc.—realized average third-quarter selling prices of between $302,200 and $851,900, way too fancy for the typical American. A multiple of house price to median income of around 3.5 times is, by common consent, a safe and sane one. Given the 2017 median household income of $61,372, a price closer to $215,000 would be the mid-American sweet spot.

Rising interest rates, too, have eroded affordability. Mortgagees refinanced en masse in 2012 and 2013, when the 30-year rate dipped below 4%, and again in 2016, when it fell to as low as 3.32%. Very different is today's 5.04% rate, up from less than 4% last year. Take a hypothetical $250,000 mortgage: That 100 basis-point swing on a 30-year mortgage raises annual payments by $1,782, a material figure for most households. If past is prologue, even a one percentage-point rise in borrowing costs will lead to widespread disruption of household moving plans.

Sales of so-called existing homes



(don't all homes exist?) fell by 4%, measured year-over-year, to a 5.15 million annualized pace in September. "Coming into the year we had a prediction for a declining resale market for 2018, and we think it is going to continue in 2019," Rick Palacios, Jr., the director of research at John Burns Real Estate Consulting, tells *Grant's*. "We've got resale volumes down 4% next year, and a big part of that is that whole lock-in effect, where we think a lot of people refinanced and they are just not going to move now. They are going to hunker down."

"The drag on GDP," adds David Rosenberg, chief economist of Gluskin Sheff + Associates, Inc., "is not going to come strictly from the direct impact [of a housing slowdown], but also from the fact that the housing market, while a small share of GDP, has the most powerful multiplier impact on the rest of the economy. There is going to be a spreading impact to financial services, into legal services, architectural services and into related forms of construction and land services."

Since the close of the fateful year 2007, household mortgage debt has declined to $9.4 trillion from $9.7 trillion even as the volume of mortgages guaranteed by Ginnie Mae has soared to $2 trillion from $444 billion. What, or who, is Ginnie Mae? It's the retiring, publicity-shy, government-sponsored enterprise that, commanding the full faith and credit of the Treasury (as distinct from the implied support of the Treasury), did not fail in the bust. Ginnie guarantees the principal and interest payments on the kind of mortgage-backed securities that wrap loans insured under the auspices of the Federal Housing Administration and Department of Veterans Affairs. So, on such MBS, there's a belt *and* suspenders.

Subprime is now under government sponsorship. Thus, with FHA insurance, middle-income borrowers with subprime-grade FICO scores can buy houses with down payments as small as 3.5%. Such loans, fashioned into mortgage-backed securities, trade with Ginnie's imprimatur.

In the run-up to 2007–09, banks dominated the FHA- and VA-insured underwriting business, and it was banks that issued the Ginnie Mae-guaranteed MBS. But nonbanks moved in after the dust of the crisis settled. It wasn't so much that they seized share from the banks as the banks—smarting under the fines assessed against them for boomtime underwriting lapses—relinquished share to the nonbanks.

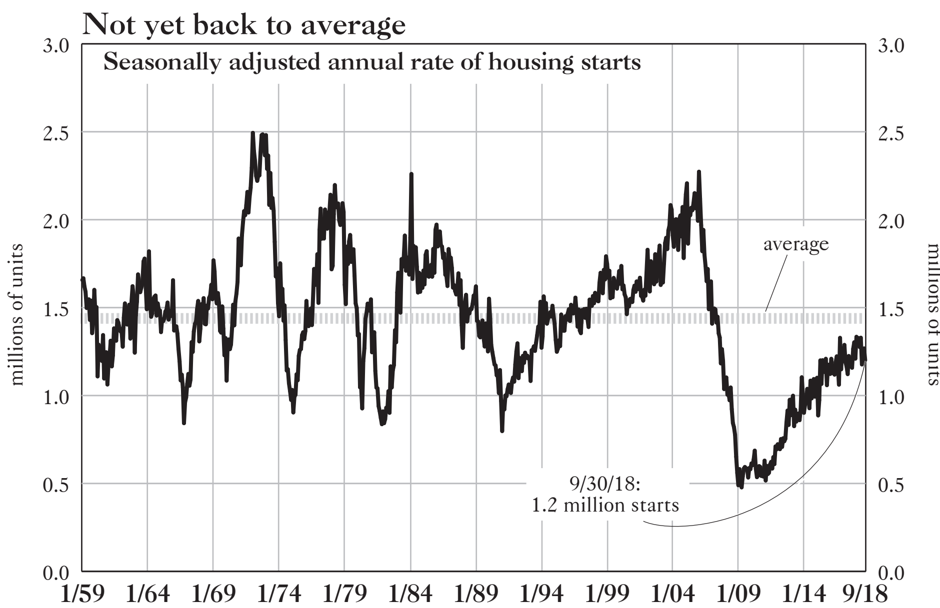
Mostly small and closely held, the newcomers are struggling. The mortgage industry expanded during the refinancing booms of 2012–13 and 2016. Now, with too much capacity and falling loan volumes (down 7%, to $457 billion, in the third quarter), profitability has plummeted, to $580 per loan in the second quarter of 2018 from $1,686 in the like period of 2016. The nonbank lenders, lacking size, name recognition and access to cheap deposits, have also been squeezed by rising costs on their wholesale, or "warehouse," credit lines.

"We are probably going to lose about 20% of the population in the Ginnie Mae market in the next 12 months," Christopher Whalen, publisher of The Institutional Risk Analyst, tells *Grant's*. "They are going out of business. They can't survive. They have hung on for as long as they can. We've had four years of declining mortgage volumes and declining mortgage profitability if you look at the MBA numbers." A washout in nonbank originators, if it led to a decline in FHA- and VA-insured mortgage-making, could produce a further contraction in housing-related activity.

That would be a problem for Ellie Mae, the leading provider of loan-origination software. Regulators responded to the subprime blow-up by drawing boxes for the regulatees to tick. Encompass, Ellie's "digital mortgage solution," manages the workflow of the mortgage brokers while briefing their minders on the regulatory and compliance staff. With Encompass at their fingertips, the brokers can order up an appraisal or some mortgage insurance with the click of a button—for which, of course, Ellie pockets a fee.

Because big banks can invest in their own IT systems, Ellie caters to the smaller lenders that came on so rapidly after 2007–09. Even so, Ellie itself is not without heft. Last year, its Encompass-enabled customers closed more than 2.5 million loans, representing a 35% share of the huge American mortgage market.

Less huge is the new theme. Ellie's third-quarter sales of $123 million and adjusted earnings per share of $0.67 compared with Street estimates of $128.1 million and $0.54, respectively. As for the fourth quarter, management points to revenues and adjusted EPS of $114.5 million and $0.37, well short of expectations for $127.8 million and $0.46. On the Oct. 25 earnings call, CEO Jonathan Corr pinned his hopes on the future: "We believe the longer-term trends will lead to a sustained purchase market as we enter the second half of 2019 into 2020 and beyond." Mr. Market, his eyes fixed on the present, marked



down the shares by 19.3% the day after the news.

There was no CFO on that call, at least no permanent CFO (Matthew LaVay, who had occupied the post, announced his resignation on May 31), a fact brought into relief by Ellie's admission that it would restate revenues for the first two periods. Interim CFO Popi Heron said she hopes to have the amended 10-Q reports filed by Nov. 9. In an 8-K filed with the Securities and Exchange Commission, Ellie warns that it's "still completing its assessment of the effectiveness of its internal controls over financial reporting as of Sept. 30, 2018, which may result in a material weakness in its internal controls."

Even before that announcement, analysts had little clue as to Ellie's true growth rate. The purchase last autumn of Velocify, Inc., a vendor of cloud-based sales-automation software, for $130 million, illustrates the confusion. Ellie has never disclosed the sales or earnings that Velocify generated pre-acquisition or what it may now contribute to parental revenue growth. It does seem material, however, given the cadence of year-over-year growth rates: 14.9%, 20.1% and 26.8% for the third, second and first quarters; management has guided for revenue growth to fall to 1.4% in the fourth quarter, i.e., the first quarter to lap the acquisition.

While Ellie Mae shares are 27% cheaper since our spring analysis, they are hardly cheap, changing hands at 70.6 times trailing GAAP earnings and 36 times trailing adjusted earnings. (Management prefers analysts to not count stock compensation as an expense.) The Street's catching the scent: As we go to press, three of the 14 analysts who cover the stock rate it a sell and only five a buy; in April, nine rated the stock a buy and only two a sell.

There may be worse to come. Ellie charges a fixed, per-user price, to which it adds a fee if its customers originate more loans than they would have done without Ellie's software. "Thus," observes Chris Gamaitoni, who rates ELLI a sell at Compass Point Research & Trading LLC, "lenders were buying more seats than needed in anticipation of future volume increases and thinking they were lowering the all-in cost per loan. This has supported Ellie Mae's revenue base in the current volume downturn."

You can see it in the company's top line. Base revenues, as a percentage of total sales, have climbed to 72% in the third quarter from 68% in 2017 and 58% in 2016; it's the reciprocal of the steady decline in success-based income. On the earnings call, Corr said that around one-quarter of Ellie's customers renew their contracts in any given year. Unless the housing market makes a quick U-turn, Ellie will likely see customers reduce staff and push back on prices in 2019. Given that the customer base skews to smaller, nonbank lenders, Ellie is at risk of any contraction in the overall mortgage-broker industry.

Weak as the market may be today, strength is on the agenda over the next five to 10 years, if indeed demographics are destiny. The millennial cohort, 92 million strong according to Goldman Sachs, outnumbers baby boomers by 15 million. As the youngsters approach their early 30s, chances are they will do as their forebears have done, marrying and starting families in their own houses. Of course, there are countervailing factors. Student debt, for one: Since New Year's Eve 2007, it's soared to $1.4 trillion from $548 billion.

Encumbered or not, though, you do need a place to lay down your head. "Maybe it means that people do buy smaller homes on smaller lots," Marvin Shapiro, CEO of Avanti, tells *Grant's*. "We've seen a lot of appetite from our builder customers to build more affordable product. Maybe they don't get the same level of finish as they would have when buyers had no student debt, but people do need that place to live. To the question of rent vs. buy . . . roughly half of renters live in duplexes or single-family homes that are for rent. So, we just don't see an environment for which there isn't a demand for traditional housing."

Belatedly, the homebuilders are adapting. "Many of the large, publicly traded builders are starting to brand affordable divisions," says Dubill, Shapiro's Avanti colleague. "DR Horton has a line called Express Homes. Toll Brothers has something called T Select. NVR has something called Simply Ryan. All of these folks are starting to offer well-designed but smaller, less expensive homes geared towards demand."

Avanti says it views the pivot to affordable housing as a five-to-10-year opportunity for the business of investing in residential lots. "If I try to find a time that feels similar to today's conditions, I would go with the mid to late 1990s when we were emerging from the real-estate recession of the early to mid 1990s but heading into an expansionary period," Shapiro continues. "At that inflection point, it is great because you are selling stuff you bought in a weaker period, and you are still buying because there is a lot of runway ahead. It is a once-every-

20-years type of phenomenon we are trying to take advantage of."

To seize the moment, Shapiro and Dubill are launching a new fund, Avanti Strategic Land Investors IX (Avanti numbers its funds like Super Bowls). Allow us here to mention that our paid-up subscribers are not being overwhelmed with demand, despite net returns on funds I through VIII in the mid teens. "Because we are longer-term focused, it takes a certain kind of disciplined capital to invest with us," Shapiro says. "We do not cash-flow in a normal way. It is lumpy based on when we sell property, and it is not liquid until it starts to perform. That is three strikes and you're out with some investors, but therein lies the opportunity when capital is short."

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