THE BIG SECRET ON WALL STREET

The New "Enron"

How a Homebuilder Beat All the High-Flying Tech Stocks of the 1990s

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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How a Homebuilder Beat All the High-Flying Tech Stocks of the 1990s

Very few investors would ever want to own an "Enron."

That's what makes this secret so compelling…

Enron's 2001 collapse was the fastest destruction of wealth in modern corporate history. It unfolded in just weeks. It was also, at the time, the biggest bankruptcy ever ($60 billion).

Enron was a total disaster. It was a business that was so poorly run, the word "Enron" is now synonymous with criminal self-dealing and corporate greed run amok.

But there's a secret about Enron not many investors understand. And that same secret has been used by a homebuilder to create massive amounts of wealth.

In this week's letter we will explain why buying the new "Enron" of housing, during a crisis, could likely end up being the best investment you'll ever make.

We don't think there's another investment, in any other well-established business, that could outpace the gains of buying the new Enron of housing.

In fact, we expect to see 10x returns in the near term.

And that's only the beginning…

What You Don't Know About Enron

Enron, for good reason, is the ultimate corporate "bogeyman."

The story goes like this. Andy Fastow, Enron's CFO, destroyed the company by using dozens of special purpose entities ("SPE") to hide losses. As the losses piled up in Enron's "merchant accounts" (investments in other companies, like volatile internet stocks) and its international divisions (direct investments in power plants, like the Dabhol power plant in India), Fastow set up structures that used more and more of Enron's own stock to cover up the losses – and did so with the approval of C-suite executives Jeff Skilling and Ken Lay.

He further defrauded the company by using his own private equity fund (LJM) to buy assets from Enron for pennies on the dollar, while charging Enron huge fees for the "privilege." This is how Fastow and a handful of his accomplices in Enron's accounting department looted the company.

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There's no question what Fastow did was unethical and contributed to Enron's collapse.

But... was it a crime?

Let's break it down.

The board of directors at Enron gave Fastow multiple ethics waivers allowing him to negotiate the sale of Enron's assets to his own private equity fund. These transactions were disclosed and were approved by the board of directors and Enron's outside lawyers and accountants.

Fastow didn't reveal that he was making millions from these transactions. But the board also never asked about his compensation from the fund. The fact that virtually all of Fastow's actions – including his looting and accounting shenanigans – were disclosed and had been signed off on by the board and the outside accountants and law firms is not only hard to explain, but it made it hard for the government to prove a crime had taken place.

So as schemes go, this one had a lot of participants. And some surprising legal complexities.

Of course, it had some things Fastow did that were clearly illegal too. Like bribing members of Enron's accounting staff. He did this by cutting them in on his illicit deals to make sure they didn't blow the whistle.

Now, let's look at a couple of other things most people don't know about Enron's collapse...

First, while the scope of the fraud Fastow perpetrated was immense – Fastow and his accomplices stole millions from the company, perhaps as much as $100 million in total – those losses do not explain how a $60 billion business collapsed.

Enron didn't collapse because of what Fastow stole, in other words.

What hurt Enron far more was bending accounting rules and hiding losses. Nobody at Enron realized how poorly the company was performing, or even knew how much debt the company was really carrying...

It was over $30 billion, not the $12 billion that was on Enron's balance sheet.

You see, Fastow didn't set up the basic systems Enron required, like simply knowing when various short-term obligations were coming due.

What ultimately destroyed Enron were bad business decisions. Decisions that were enabled by the company's absurd accounting.

Enron's worst decisions involved the billions it lost on bad investments in its international division. These investments were both huge and very likely to fail from the beginning.

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The Dabhol power plant is a good example. Enron built it in the mid-1990s. Who in their right mind would've bet $300 million on an enormous construction project in a country as poor and as unstable as India?

India wasn't able to pay even half of its bills, from the very first day. The Dabhol plant still can't pay its bills and has been shut down and "restructured" numerous times.

Or how about buying the municipal water system in Buenos Aires, Argentina?

Enron bid *twice* as much as any other bidder. But apparently did almost no due diligence on the status of the business, or its IT systems. The investment was a complete loss, $600 million, from day one. The entire company had been looted; its computer systems destroyed. Enron had no way to bill its customers for the water systems it "owned."

To cover these losses, and dozens of others like them in places like Brazil and Guatemala, Enron sold two of its most valuable U.S. assets, Enron Oil and Gas and the InterNorth pipeline. The pipeline, one of the most valuable pieces of infrastructure in the U.S., was sold to a group (Kinder Morgan) headed by Richard Kinder, Enron's former president, for $60 million.

Today Kinder Morgan (KMI) is worth more than $45 billion.

The Enron Oil and Gas deal was even worse. Enron swapped its ownership in what is now EOG for $600 million in cash and ownership of some of EOG's assets in China and India. The foreign assets never amounted to much.

But EOG went on to become the best U.S. shale oil driller — pioneer of the Bakken oil play. It's now worth $72 billion.

It's easy to question why Enron made these decisions. But there was a strategy. Enron didn't just want to sell its best assets. It wanted to sell virtually all its capital-intensive businesses.

In the summer of 2001, just days before its collapse, Enron arranged to sell all of its international assets to Sheikh Zayed, the Emir of Abu Dhahi. The deal was done – it just didn't close on time because Zayed was sick. And then he died of a kidney ailment.

If he hadn't died and Enron had received the $7 billion in cash it was promised, the company probably wouldn't have gone bankrupt – despite the Fastow crisis.

The bottom line: Enron went bankrupt because it made some terrible business decisions. It borrowed way too much money to buy very risky assets… from internet stocks to foreign power plants. These were financial disasters.

Then it had to sell some of its very best assets to generate cash to cover these losses.

Despite all the dumb things it did, Enron might've survived, because it did one thing brilliantly…

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Enron pioneered an entirely new kind of energy business model.

Enron's CEO, Jeff Skilling, figured out Enron could earn far higher returns on assets and invested capital by not owning oil and gas properties or energy infrastructure.

Instead, he cut deals to help finance oil and gas drilling. Doing so bought the rights to a percentage of the production. Likewise, Enron would bid for pipeline access when it needed to transport oil or gas, renting what it needed, when it needed it. This allowed Enron to sell energy – both oil and gas, and later electricity – in various U.S. markets without actually owning the underlying assets.

No one in the world was better at understanding the market dynamics of energy in America than Enron – nobody else came close. Enron could guarantee long-term, fixed rate prices for natural gas, for example, to energy companies across the U.S., allowing them certainty of supply and price. It could also generate big profits by moving natural gas from one spot market to another, when prices spiked. Or by selling electricity from a cheap power grid into an expensive one, like California's.

In 2001, when Enron went bankrupt, its top natural gas trader, John Arnold, made the company $750 million on his trades alone. He was given an $8 million bonus that year.

After Enron went bankrupt, he set up a hedge fund – essentially Enron's old trading floor. Arnold's firm made 150% returns in 2005. And John Arnold became the youngest billionaire in American history. He retired from trading in 2012 when he was only 38 years old.

Had Enron survived the crisis of 2001, we believe it's likely they would've become something like the Goldman Sachs of energy. And Ken Lay and Jeff Skilling would've been seen as visionaries, not crooks.

But Zayed kicked the bucket. And Enron went straight down the toilet.

Enron Failed – But Was That a Crime?

Rather than throwing the book at the people who were looting the company, Andy Fastow and his accomplices in the accounting department Michael Kopper and Ben Glisan, prosecutors instead accepted negotiated guilty pleas with these criminals and cut their jail terms in exchange for testimony against less culpable actors, a practice known as "flipping down."

It's something prosecutors usually try to avoid, because the result is that the more culpable actors fare better than those below them. It feels unjust. In the case of Enron, Fastow would serve less than 10 years.

As part of their guilty pleas, Fastow and his accomplices agreed to testify, under oath, against people who had nothing to do with the underlying fraud or embezzlement – like the entire Arthur Anderson accounting firm and four bankers at Merrill Lynch – who simply bought some barges as a favor for a client (Enron)

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and made a profit for Merrill Lynch.

They had no duty to ensure that Enron was accounting for the sale of these barges accurately. And they had no knowledge that Andy Fastow's private equity firm was defrauding Enron when he repurchased these barges from Merrill six months' later. Yet, they ended up in prison.

And so did Jeff Skilling.

Fastow was supposed to have Skilling sign off on all the deals his private equity fund negotiated with Enron. If he had done his homework, Skilling would've known about the graft and, we surmise, would've stopped it.

But Jeff's signature isn't on any of the documents – not one.

Skilling clearly wasn't aware of what Fastow was doing. And Fastow's misconduct didn't come to light until months after Skilling had left the company. There's also no evidence whatsoever that Skilling knew that any of the accounting was fraudulent or that he ever tried to enrich himself at the company's expense. But that didn't seem to matter to the prosecutors.

The primary issue was whether or not Enron's executives, by making bad business decisions, had committed a crime.

The government alleged Skilling and others had defrauded investors by not providing "honest services." But the way the statue was written, to commit this crime required that someone receive some inducement – like a bribe or a kickback.

There's no evidence of that anywhere. In fact, Skilling owned one-million shares of Enron when it collapsed. He lost a fortune.

And he was never accused of taking a bribe or being involved financially in any of Fastow's schemes. Likewise, in the case of Arthur Anderson, they may have given Enron terrible advice. But they didn't do so in a way that benefited their firm or their partners illegally.

The Enron prosecutions resulted in the collapse of the accounting firm, Arthur Anderson... the conviction and jail terms for the team of bankers at Merrill Lynch... and of course, the convictions of both Jeff Skilling and Ken Lay.

And many of these convictions were later overturned, including Jeff Skilling's.

> *"So what" you might say, "Enron and everyone associated with it was a crook in one way or another."*

True, the folks working at Enron did a terrible job from a fiduciary standpoint. They deserved to lose their jobs and perhaps their stock options – and they did.

But sending people to jail who did not break the law, as it was written at the time, is a dangerous precedent.

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The lawyers of the government's Enron Task Force should have been censured and fired.

But is that what happened?

No, of course not. The Enron Task Force would, more or less, run the Department of Justice for the next decade or so.

When Alaska Senator Ted Stevens was falsely accused of receiving a bribe in July 2008, he lost his Senate seat. That shifted the delicate balance of power in the Senate and set the stage for the narrow approval of Obamacare. It also ruined the career and the reputation of a man who'd served his country in World War II and had been in the Senate for 40 years.

But was Senator Stevens guilty of anything at all?

No. He was the target of the Justice Department, which simply wanted to remove him from power.

Later, in 2009, the judge would throw the case out, saying the indictment was *"the worst case of prosecutorial misconduct he'd ever seen."* He also initiated a criminal contempt investigation of six members of the prosecution team and appointed a special prosecutor to investigate because he didn't trust the Justice Department's own Office of Professional Responsibility.

Any idea who was most responsible for the false prosecution of Senator Stevens?

According to the special investigator's report, it was the acting assistant attorney general of the Criminal Division of the Department of Justice, Matthew Friedrich. He'd just been promoted from his previous role as chief prosecutor on the Enron Task Force.

And when Bob Mueller was appointed to lead the Justice Department's investigation of Trump's supposed ties to Russia, you'll never guess who Mueller picked as his top deputy?

Andrew Weissman, who was the head of the Enron Task Force.

It was Weissman's decision to bring charges against the entire Arthur Anderson firm. The conviction was overturned because of Weissman's improper jury instructions. But by then Arthur Anderson had been destroyed.

It's an interesting thought experiment to wonder what would've happened if the Enron prosecutors, rather than being lauded and promoted for sending Skilling to jail and Lay to his deathbed, had instead been held to account for their convictions being overturned.

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What if they had been censured for their reprehensible deal making with the convicted criminals?

Ted Stevens wouldn't have lost his Senate seat. Obamacare would have never happened. And maybe the Russia-Trump nonsense would have never happened either.

So… maybe there's more we can learn from Enron than most people understand.

Either way, the key lesson we take from the Enron debacle is that honest accounting is paramount. Companies that try to cook their books can fool investors for a little while, but ultimately they end up fooling themselves.

And the other thing we've learned from Enron is that businesses that can capture the profits that flow from major capital investments – without owning them – can make enormous returns…

And that brings us to the homebuilders whose stocks have been crushed so far this year.

The "Enron" of Homebuilding

Most homebuilders require enormous amounts of capital.

They buy up big plots of land in areas where they think they'll be able to build and sell houses. Doing these land deals is exciting: when they buy the right properties, in the right places, at the right price, they can make a lot of money.

That's why most homebuilders brag to investors about the size and quality of their land holdings. Inside these companies the "land men" – the deal makers – are kings.

Like at Enron's international division, the deal makers inside these homebuilders make huge, long-term investments with "other people's money." They have enormous financial incentives to make a deal – any deal. And there are few consequences for making a bad deal, especially considering that if a land deal goes bad, that failure typically comes years later.

So, what do you think happens over time?

Inevitably homebuilders end up with too much land, in the wrong places, bought at the wrong time. Sooner or later, a recession hits, land values plummet, and home sales stall. Here is a list of top homebuilders and a look at gross margins, return on assets ("ROA"), and return on equity ("ROE").

Plenty of homebuilders have gone bankrupt because while the value of their land holdings fell, the amount of money borrowed against the land didn't.

And on the surface, NVR looks just like the other national homebuilders.

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Homebuilders by the Numbers

Homebuilder	Operating Margin	ROA	ROE
PulteGroup	29.7%	18.1%	27.5%
DR Horton	26.4%	14.9%	21.7%
NVR	**25.7%**	**25.9%**	**39.5%**
LGI Homes	24.7%	5.8%	10.8%
Lennar Corp	24.1%	11.2%	16.2%
Taylor Morrison	24.0%	8.9%	15.1%
KB Home	21.5%	9.2%	15.7%
Beazer Homes	19.4%	5.6%	12.4%

It builds homes in 36 metropolitan areas under a range of brands, such as Ryan Homes and Heartland Homes. It sells to both first-time home buyers and "move-up" buyers. Its largest market is the D.C. metro area.

And in the data below, if you look at NVR's gross margins, you won't find anything special. On a per-house basis, the company is only roughly as profitable as everyone else. But if you look a little closer, you'll find that NVR is the "Enron" of homebuilding.

NVR's returns on assets and its return on equity is off the charts. In the ways that should matter most to investors, NVR isn't like any other homebuilder. It's vastly more profitable.

Compared to the industry average, NVR provides more than double the return on equity. Its stock should be worth at least twice as much as any other homebuilder.

Normally when you find a company that has such a big advantage in return on equity it's because the company is highly leveraged. But that isn't the case here. In fact, NVR carries zero net debt.

So how is this possible? How in an industry where everyone's product and process is so out in the open, how could the company be so dominant and so much better than its peers?

Because NVR is what Skilling was trying to create at Enron.

NVR figured out a way to profit from massive capital investments – without having to own the assets. Here's how it happened. It began almost by accident...

Like Enron, NVR suffered a financial collapse during a national economic downturn.

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NVR filed for bankruptcy on April 6, 1991, on the heels of the U.S. savings and loan crisis. Its bankruptcy was complicated because, like Enron, NVR had a CFO, Anthony Satariano, who embezzled money from NVR's finance operations.

And, like Enron, the embezzling wasn't the real problem.

NVR failed because of major changes to the tax code. The 1986 tax reform removed tax benefits related to limited partnerships that invested in real estate. These incentives previously led investors to pile into real estate developments, leaving most of NVR's key markets dramatically over-built. By 1990, NVR's inventory was 50% above normal. Then a mild recession hit. Revenue from homebuilding fell in half over three years. The hundreds of millions worth of land on its books became a burden the company could no longer finance.

While it was still in bankruptcy (and unable to acquire additional land), the company pioneered a new business model. Necessity was the mother of invention.

Instead of developing large tracts of land and building houses, NVR partnered with independent developers to buy options on lots. NVR would still sell lots in NVR-branded communities. But rather than owning the land outright, NVR would pay a small fee – an option – for an exclusive right to resell the land to homebuyers. The developers were only paid for their lots after they were sold by NVR.

That put the entire risk of land prices on the developer. And it meant that NVR's capital outlay – the cash it had to spend up front – was a fraction of what it would be following a more traditional model.

NVR then further reduced its capital needs by only starting construction after a new home was sold. Thus, it only built houses that were already paid for, via down payment and mortgage lending.

In this way, NVR was able to sell lots it didn't actually own. And it could sell houses without having to finance their construction. Just as Enron figured out how to earn money selling oil and gas it didn't produce, using pipelines it didn't own – NVR figured out how to sell houses it didn't have to pay for on land it didn't own.

NVR's new business model gave it an *overwhelming* advantage over other builders. Remember, most homebuilders are controlled by their founders, people who have long histories as developers. These founder-run companies are attached to land development for emotional, not financial, reasons. They are constantly looking for "deals" – development opportunities. They let their subcontractors deal with building houses.

On the other hand, bankruptcy forced NVR to find a new way. NVR discovered, almost by accident, that despite the glamor and big profits that were possible in good land deals, on average the returns on development were poor. And the risks were big.

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After bankruptcy NVR decided to focus solely on pioneering new and better ways to build houses. Rather than dealing with the endless headaches faced by developers in multiple states – dealing with hundreds of different legal jurisdictions, thousands of individual landowners, zoning boards, etc. – NVR would focus its capital and efforts on building better homes, far more efficiently.

In the 1990s, NVR began building more and more of its houses inside its factories, where it could produce the components faster and cheaper and with far higher quality standards. These factories were geographically close to NVR's target markets (NVR is selective about where it builds... for example, it isn't active at all in Texas or California... big markets for most other homebuilders).

As a result, when it emerged from bankruptcy, NVR was building detached homes in only 86 days.

Thanks to its unique strategy, NVR has been one of the best investments of the past few decades.

It's one of the very few businesses we consider "must own."

NVR emerged from bankruptcy in 1993 and its stock began trading again in 1996. Over the next 20 years (1996-2016), NVR was the highest returning investment of any company with a market cap over $100 million – beating all the high-flying tech stocks of the period. The company earned investors almost 30% a year in the period, despite the mortgage crisis of 2008-2011.

When Porter first began writing about the company in 2007, he thought NVR had the greatest comparative advantage of any company against its peers, in any sector, in the entire U.S. economy. *"When you decide to speculate on a bottom in homebuilders, NVR is the only stock to consider."* At virtually every investment conference or analyst meeting, Porter talked about what made NVR so special and gave it such an incredible advantage over other builders.

Most of the time, nobody wanted to hear it. Most investors didn't take homebuilders seriously as an investment because historically the industry was dominated by "mom & pop" builders with close ties to local financial institutions (and zoning boards). The national homebuilders were, by and large, terrible businesses. National homebuilders had very low returns on assets because they owned billions worth of land, financed largely with debt... and paid up-front for developing the land, taking on all kinds of risk.

Similar to the airline industry, investors often sarcastically remarked that homebuilders were "perfectly hedged" investments. When times are good and they make money, the cash ends up being reinvested into more assets (more land or in the case of airlines, more planes). Investors don't ever earn big dividends. And when there's eventually a recession, both homebuilders and airlines frequently go bankrupt. Homebuilders are trapped holding onto huge amounts of land they suddenly don't need and can't afford. And same the airlines and their planes.

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In other words, no matter the economic environment, traditional homebuilders, and most airlines all too often wind-up losers.

Warren Buffett once joked that airlines have proven so toxic to investors that, “if a far-sighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down.”

You can put homebuilders in the same toxic category.

Even during good times, the huge amounts of land on most homebuilder’s balance sheets means that they generate low returns. There’s no other national homebuilder that can consistently produce even double-digit returns on assets.

Meanwhile NVR’s return on assets, every year between 1999 and 2007, was well over 20%. Even during the crisis of 2008-2011, NVR produced positive cash flows every year, and only reported losses in a single quarter. After recovering from the crisis, NVR’s return on assets continued to increase year after year, from 10.4% in 2013 to back over 20% again by 2018.

Incredibly, NVR still has this advantage: none of the other homebuilders have fully embraced NVR’s asset-light model.

Currently NVR has 98.3% of its land inventory held with options. Less than 2% of its land inventory is owned outright. Out of the 15 major, publicly traded homebuilders, only eight have more lots owned than optioned. And only DR Horton comes close to replicating NVR’s structure, with 75% of its land held with options.

Despite the obvious differences between NVR and the other national homebuilders, in terms of strategy, and operational and financial performance… and despite decades of share-price outperformance… very few investors understand just how enormous NVR’s asset-light strategy is for shareholders.

The best proof of the company’s incredible capital efficiency is its relentless share buybacks. Instead of buying more and more land every year, NVR uses virtually all of its free cash flow to buy its own stock, especially during selloffs in the market.

During the housing boom of 2003-2006, NVR bought $1.5 billion in stock, an amount of capital equal to virtually half its market capitalization in 2007. How many other companies, in any industry, could have possibly returned so much capital to shareholders while continuing to expand at a record pace?

Even so, back then NVR didn’t normally trade at any significant premium to other homebuilders. And back in 2007 – at the beginning of the real estate collapse — investors didn’t want anything to do with the company. NVR was trading for only four times free cash flow!

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Porter thought it was one of the greatest investment opportunities of his career:

> *"... when should you buy NVR? The stock seems to have found a bottom around $400 per share. The company's operating earnings peaked in 2005, when it made $1.1 billion before taxes. I think it's safe to assume normalized earnings over the long term will average out at about half this peak level – or about what the company earned in 2002. Let's say $500 million per year. Putting even a low multiple on these earnings (6x) to adjust for the company's inherent cyclicality gives you an estimated market cap of $3 billion – 30% more than the stock price today. I'm sure my timing is way, way too early. But I'm prepared to average down and be very patient. If you're willing to do the same and buy shares regularly over the next three to five years, you should buy shares of NVR Inc. (AMEX: NVR) below $450. Don't use a stop loss on this position, as NVR stands almost no chance of going bankrupt, but sentiment in the sector is very likely to decline. I wouldn't put more than 4% of my portfolio into this position, given the volatility. And I wouldn't invest any money I thought I might need before 2020. Why buy now? The company is probably worth two or three times its current price. I believe earnings will begin to improve here long before the rest of the sector. And thanks to the company's relentless share buybacks, the compound returns on this stock will likely be more than 25% per year for the next 10 years. That's a great investment. But it's going to be a wild ride, so you'll have to be very, very patient."*
>
> *"What You Need to Know to Profit From the Collapse in the Housing Market"*

-Stansberry's Investment Advisory, October 31, 2007

That forecast has proven to be stunningly accurate.

NVR's earnings bottomed the next year, in 2008, at $100 million. Then they almost doubled the following year (2009) to $192 million, but remained around those levels, until the mortgage crisis finally ended in 2012.

In 2013 NVR's earnings broke through $200 million again ($266 million) and from there they grew steadily.

In 2023, NVR earned $1.6 billion.

And... what was the average of NVR's earnings since 2008?

From 2009 through 2023, NVR has earned $649 million per year, on average.

That's almost to the penny what Porter forecast 17 years ago. Virtually all the company's earnings have been used to repurchase stock. Over the last 10 years, NVR has repurchased more than $9.8 billion worth of shares – once again, that's roughly 40% of its market capitalization today ($26.3 billion).

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As Porter has described before in other long-term recommendations of very capital efficient businesses, such as The Hershey Company (HSY), the incredible advantages of these business models only become extremely apparent over time. It is difficult to accurately model the impact of both increasing earnings and decreasing share counts, because small changes to assumptions will have a big impact on earnings per share over time. But regardless of the exact figures, the combined impact of these compounding returns is truly extraordinary over the long term.

Consider the impact of NVR's growth and share buybacks since the last housing boom.

Back in 2005, at its last peak in annual earnings, NVR earned GAAP net income of $697 million, and NVR's shareholders earned $110 per share.

NVR wouldn't surpass that level of profit until 2018, 13 years later, when it earned $792 million in GAAP net income. That's only a 13.6% increase from its previous "peak" earnings. But, by 2018, NVR had also repurchased billions in stock. That meant that total outstanding share count fell, almost in half, to 3.6 million shares.

As a result, NVR's earnings per share in 2018 were $219 per share, a 76% increase over its previous peak. In other words, over time, NVR's earnings per share completely outpaced merely the growth in its underlying business. Only businesses that are extremely capital efficient can produce those kinds of compounding returns on relatively slow growth businesses.

Over time, these compounding returns are stupendous. Over the last 12 months, NVR earned $1.5 billion, or $484 per share. So, while earnings have more than doubled since the last peak, earnings per share increased 440%.

If you followed Porter's advice to invest in NVR below $450, you would have bought shares in the fall of 2008 and in the spring of 2009. You would have earned more than 18% per year through 2023!

But how many investors were willing to buy a homebuilder in November 2007, when the entire homebuilding / mortgage industry was collapsing? Or at various points in the fall of 2008 and the spring of 2009, when during the extremes of the financial crisis, NVR traded below $400/share?

It's obvious that soon there is going to be a significant correction in housing. It could be several years before NVR sees a new high in peak earnings. Earnings could fall in half next year – or maybe more.

If that happens, we know from experience that NVR will weather the crisis better than most homebuilders. Its balance sheet isn't weighed down with debt related to land ownership.

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In fact, the company has more cash than debt currently. NVR clears inventory much faster too, which makes a big difference when prices are declining. NVR turns over its inventory 3.7x a year, compared to the industry's average inventory turn of 1.2x a year. That means NVR is sitting on 94 days of inventory at any given time, instead of an average of 304 days for its competitors.

NVR currently trades at a P/E of 18, compared to a P/E on average of 15 over the past five years.

The trouble is, NVR will probably get cheaper if the housing crisis gets worse. And that's likely, in our view…

We think we are only in the beginning of a recession that could be longer and more painful than anyone currently expects.

The Federal Reserve has explicitly mentioned home prices as a key target of its interest rate hikes. It's impossible to know how high interest rates might go. But the July labor market data showed that the unemployment rate jumped from 4.1% in June to 4.3% in July. This triggered a reliable recession indicator known as the Sahm Rule, created by economist Claudia Sahm, which states that if the three-month average of the unemployment rate rises by a half-percentage point or more over the lowest three-month average over the previous year, the economy is in recession. Consumer distress is rising and rising unemployment usually coincides with lower corporate earnings, which leads to more layoffs in a self-reinforcing cycle. This latest string of economic data now has the market pricing in at least one rate cut by the September meeting.

On the other hand, we don't think that this downturn will be anything like the collapse of 2008-2011 – at least not in housing. There's no widespread mortgage fraud. And, outside of a few areas like Miami, there's little evidence of a bubble.

There is also way more demand for housing than supply.

Since the last crisis, the housing industry has consistently built fewer homes and apartments than historical averages. Specifically, America's housing market remains 4.6 million units below trend. There's no question that declining affordability will reduce the number of people who can qualify for a mortgage. And that means homebuilders are going to have to lower prices, which will reduce margins and profits.

But we don't believe that NVR, or the other homebuilders, are facing anything like the crisis of 2008-2011. Instead, we believe NVR will see a moderate decline (30% or so) in earnings, on average, over the next five years, with most of the decline in earnings happening in 2025.

Looking at NVR's share price, you'll see a significant bottom was reached in early 2020, when the share price hit the $2,500 range.

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So… when should you buy…?

We recommend buying shares of NVR when they trade below $3,500 per share. How far below?

That's impossible to say… but we do expect shares in NVR to trend lower over the remainder of the year.

Why would we recommend buying a stock that we expect is probably going to decline for a while?

As with Porter's original recommendation in 2007, we know that NVR will survive the downturn and, when mortgage rates begin to decline again, the company will continue to grow, and rapidly. Patient investors, who are willing to buy across this trough and hold until the next peak, will likely see extraordinary returns, probably around 20% annually.

We do believe understanding NVR's dominance relative to its peers is one the few bona fide secrets in the market.

Porter Stansberry

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Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team, you can get acquainted with us **here**. You can follow me (Porter) on **X** here: **@porterstansb**

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