Get contrary on Toll: hedge fund: Building opportunity

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Illustration: Black & White Photo: Mike Mergen, Bloomberg News / At 6.5 times this year's earnings, Toll Brothers is a steal, hedge fund Goodwood Inc. argues. Above, a Toll construction site in Pennsylvania.

Chart/Graph: Bloomberg News, National Post / TOLL BROTHERS INC.: TOL/NYSE: (See print copy for complete chart/graph.)

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Hedge fund Goodwood Inc. has nothing but good things to say about Toll Brothers Inc. Considering Goodwood's track record as of late, including big scores on Dofasco Inc., Creo Inc., Great Atlantic & Pacific Tea Co. and Laidlaw Inc., it's not a bad idea to listen.

Goodwood figures that Pennsylvania-based Toll Brothers, which builds new luxury homes and other residential dwellings, is a "blatant case" of a top-quality business trading at a bargain-basement price.

Over its 19 years as a public company, Toll has produced annual compounded earnings-per-share growth of 24.9%, posted 13 consecutive years of record earnings, 14 consecutive years of record revenue and 15 consecutive years of record order backlogs, Goodwood noted in a recent commentary.

Even better, its net debt to net capital ratio is the lowest it has ever been. And its target market is poised to expand. Even the company's managers, who have been around since 1967, continue to be major shareholders.

At 6.5 times this year's earnings, it is a steal, Goodwood argues. "Have you ever seen such a blatant case of a high-quality business selling for such a discount P/E multiple?"

The hedge fund now owns a "medium-sized position" in Toll Brother at an average cost of US$32.90 a share.

The stock (TOL/NYSE) closed yesterday at US$33.52, up US62 cents. It is trading well below its 52-week high of US$58.67.

Goodwood doesn't buy the doom-and-gloom prediction that the U.S. housing market, addicted to cheap credit, is about to crash like George W. Bush on a mountain bike. It's a view that's running against the crowd. Yesterday, UBS downgraded Nordbord Inc., the second-largest producer of oriented strand board, to "sell" partly based on expected weakness in U.S. home construction.

Toll Brothers is focused on affluent home buyers. Its average home price in 2005 was US$660,000, compared with US$235,000 for most of its publicly traded peers. Demand is declining from record levels, as shown by recent sales declines at Toll Brothers. But Goodwood thinks the housing market will enjoy a "soft landing rather than a thud." Demand for homes will continue to increase, Toll Brothers predicts, and the growth in the number of affluent homes will outpace the general population.

"We consider this position to be an exercise in contrarian investing, as not a day passes by without negative commentary in the popular press concerning the dismal future of the U.S. housing industry," Goodwood wrote. "And what if the consensus is wrong? What if there are still some years of good growth ahead?" Keith Kalawsky

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NEW BACKER? Shares of Bema Gold Corp. and Arizona Star Resource Corp. have raced higher in the past two days amid optimism that Barrick Gold Corp. will step in and help the companies develop their rich Cerro Casale gold and copper property in northern Chile.

Bema and Arizona Star had originally teamed up with Placer Dome Inc. to build a mine at Cerro Casale, but Placer decided to bow out late last year. Then came Barrick, which bought Placer to become the world's largest gold miner.

Now, investors are reading the entrails in the wake of the takeover and finding signals that Toronto-based Barrick may be willing to resurrect the deal.

Barrick already has extensive operations in Chile, and CIBC World Markets analyst Barry Cooper sent a note to clients Tuesday pointing out that Barrick recently bought into a copper-gold project in Pakistan called Reko Diq.

"What does Barrick's move in buying into Reko Diq have to do with Cerro Casale?" Mr. Cooper wrote. "A comparison of the two deposits in our opinion shows how Cerro is superior to Reko Diq, suggesting that ABX [Barrick] will want to do a deal on Cerro Casale. We think the stock [of Bema] would react positively to such an announcement."

Bema has risen 9.5% to $5.15 in two days as 42 million shares changed hands on the Toronto Stock Exchange. Arizona Star has risen 14% since Wednesday and finished yesterday at $10.90. Boyd Erman

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INVESTORS SHRUG Falling natural-gas prices have analysts concerned that natural-gas-weighted royalty trusts will be forced to cut distributions.

But investors don't seem to be taking much notice. Take Advantage Energy Income Fund as an example.

Earlier this week, Advantage reported that production declined 17% in 2005 after capital expenditures of $100-million during the year. If you adjust for debt, production dropped 22% on a per-unit basis, according to CIBC World Markets analyst Brad Borggard.

And isn't going get any better. Mr. Borggard estimates 2006 production will drop to 18,225 barrels of oil equivalent per day, from 18,525 boe/d, based on a capital program of $100-million.

"Without a material rebound in natural gas prices, we would not be surprised to see the trust reduce its monthly distribution from the current rate of 25 cents per month," Mr. Borggard said. The second half of 2006 could bring a cut to 23 cents a unit, he said. Even after this cut, the company's payout ratio will rise to 85%, compared with the group average of 69%.

"Management has recently indicated that it is considering the pursuit of a lower payout ratio model, similar to the majority of Advantage's peers," he said. "For these reasons, we could see a distribution reduction greater than our current forecasts imply, a reduction in the trust's capital development program, or a combination of the two."

Mr. Borggard calls the trust a "sector underperform." Indeed, seven out of eight analysts call the trust a "sell." The trust is down 6 cents over the past two days, closing at $22.20 yesterday. Carrie Tait