VENATOR
CAPITAL MANAGEMENT LTD.

NOTHING HAPPENED LAST MONTH SO LET'S TALK ABOUT FORESTAR!

HEDGE FUNDS (Inception)	JANUARY 2024	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-1.9%**	**-1.9%**	**8.8%**
Venator Select Fund (September 2013)	**-2.7%**	**-2.7%**	**7.1%**
S&P/TSX Total Return (March 2006)	0.6%	0.6%	6.4%
Russell 2000 (March 2006)	-3.9%	-3.9%	7.1%
S&P Toronto Small Cap (March 2006)	-0.4%	-0.4%	2.8%
S&P 500 (March 2006)	1.7%	1.7%	9.9%

ALTERNATIVE MUTUAL FUNDS (Inception)	JAN 2024	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**0.3%**	**0.3%**	**7.1%**	**0.2%**	**3.2%**	**4.1%**
Venator Founders Alternative Fund (July 2021)**	**-2.0%**	**-2.0%**	**15.7%**	**-**	**-**	**-**
B of A Merrill Lynch High Yield Index (August 2008)	0.0%	0.0%	9.2%	1.9%	4.3%	4.4%

** As of January 31, 2024*
*** Venator Founders Alternative Fund, which holds the same securities as Venator Founders Fund, is available as a Liquid Alternative Mutual Fund; it is eligible to be held in both registered & non-registered accounts.*
**** Performance data prior to January 24, 2020, relates to Class F Units of Venator Income Fund, which was distributed to investors on a prospectus-exempt basis in accordance with National Instrument 45-106*
***** Venator Offshore Fund is available as the US dollar version of Founders Fund strategy*

Markets were broadly calm until the last hour of trading yesterday, the last trading day of the month. The outlook for inflation continues to be lower. The economy continues to move ahead at a slow pace. Interest rates are stable in anticipation of rate cuts this year, although the timing of these cuts is the greatest uninteresting source of debate (for the record we never thought that a spring cut was going to happen, nor do we see rates falling below 4% in the next two years). The S&P500 was dragged marginally higher by the AI narrative of the Magnificent 7, which is itself threatening to kick several members out of the club; the equally weighted S&P500 was down. The consumer had a pretty good holiday season, people are still eating out, and everyone is getting excited about election year infrastructure spending which is keeping cyclicals afloat despite uncertain outlooks. Even the hard landing crowd has all but disappeared while no one is out there calling for a strong economy either – it's either no landing or a soft landing. We imagine most of this years' drama will center around Trump-Biden II once that circus hits the road. Until then, the market can fret about spring vs summer rate cuts, which is an immaterial difference in the grand scheme of things (even if the distinction did cause our funds to drop by over 2% in the final hour of trading in the month – thanks Mr. Powell!).

With that said, let's talk about US housing! We realize we probably talk about it more than anyone out there, but we still think it will be a very profitable sector over the next five years, and we are still heavily invested in the sector, so it occupies quite a bit of our time. That there is a housing shortage from fifteen years of underbuilding is well accepted. If mortgage rates can hold in the 5%-8% range, that should keep resale home supply at bay. The combination of these two factors is a best-case scenario for homebuilders.

It was a strong sector last year, but despite houses being the majority of most of the population's net worth, it is not a sector that gets a lot of attention. It isn't technology, it isn't frequently bought, there is little "style/fashion", there are very few investible companies, and as such, it is difficult for investors to move a lot of money into it. It also can't really grow that fast because it takes years to develop land and months to complete the "stick and brick" phase of construction. But change is happening, which can benefit everyone in the sector willing to look.

Historically, builders used to hold 4-6 years' worth of inventory/land for planning purposes. With the debt required to finance these in advance land purchases, housing was viewed as a risky venture, an issue that came to light in 2007-2009 when the land values collapsed but the debt still came due. This was why housing companies have historically been marked between 1-2x book value rather than earnings; the earnings were short-term, but the asset heavy book value was what you were worth.

This is changing as the highest valued homebuilders are shedding their land and decoupling from book value limitations on valuation. This has happened in two steps. The first step was companies moving to three years of “owned” land inventory and three years of “optioned” land. Land options allowed them to retain control but give up the land in the event of another real estate crash (at a cost). How do you value a company on a multiple of book value when they become asset light? You go to price-earnings ratios. The most asset light homebuilders have the highest P/E ratios, such as NVR Inc (NVR). It suggests that as these companies transition to asset light models (which has the added benefit of strengthening the balance sheets as the land gets monetized), these companies turn into high ROE cash generating machines. DR Horton, the largest builder in America, has said that they are in the turnover business now, not the land speculation business. With gross profit margins of more than 20% and a time to build of 4-5 months, it is unlikely they would lose money on a house with such fast turnover relative to the risk of holding land over six years. If the other homebuilders all piled on this inventory light model, there would still be doubles out there as many still trade below 7x earnings, with an added benefit of whatever they can do with the excess cash they generate by selling off the land without replenishment.

As builders increase their outsourcing of these businesses, there will be a lot of growth in land development for those with the financial strength to hold it. This is also becoming an increasingly profitable business as builders appear willing to give up 10% of their gross profit dollars in exchange for the working capital efficiency outsourcing land development gives them. You might be thinking: why would one want to invest in the asset heavy part of the business the homebuilders seem so desperate to offload? The reason is that there is added profitability in the value add of developing the land, and there is profit in holding the land for builders under option contracts. In fact, a well-run land banking/development company can have similar gross and operating margins to a top homebuilder. It won’t have the return on assets, a clean balance sheet and inventory turnover, but it would still be a very strong business. Furthermore, with much of the land optioned out or being contractually developed for builders at cost-plus, it wouldn’t necessarily carry the real estate value risk that got the sector into trouble fifteen years ago.

Forestar (NYSE: FOR, $31.25) was the land development business spun out of DR Horton (Americas largest homebuilder) several years ago and is a major step in DR Horton’s asset light strategy. As a result, nearly 85% of Forestar’s lots sold are to DR Horton, which makes sense given they recently owned it and its largely their land pre-spin off (DR Horton still owns 63% of Forestar stock). The key numbers here are that DR Horton wants to double their business with Forestar over the next five years (approximate on the timeframe but concrete on the doubling), while at the same time, Forestar wants to move to lower their proportionate business with DR Horton to below 70%. Normally, we would be concerned about customer concentration at this level, but in this case, we consider it a strength given the strong market backdrop, that DR Horton is the strongest partner you can have, and that DR Horton has a strong vested interest in Forestar’s strength given its 63% ownership position. Furthermore, Forestar gets favorable financing rates to its competition, a major advantage in a business where inventory needs to be carried for years. Remember, DR Horton’s current strategy is to maximize volume with fast turnover to maximize working capital value. That means growth for their preferred suppliers.

Without getting too far into the weeds, the numbers break down quite simply from a few angles for Forestar and prospective value creation. For our purposes, we are assuming these are roughly five-year goals for both Forestar and DR Horton. Forestar wants to take their market share from 2.3% to 5%+, and DR Horton wants to double their business with Forestar. That suggests a doubling of lots sold for Forestar, all else being equal. For Forestar to take its business with DR Horton from 85% to 70%, that would amount to 400% growth in their non-DR Horton business, albeit from a very small base. This would amount to 140% overall growth in lots. Furthermore, we expect that lot prices will continue to increase 3-5% per year and gross margins will stay stable over time (noting that lot prices are up currently while house prices have stagnated – scarcity matters). This gets us north of 150% growth in five years, a number we don’t consider particularly conservative or aggressive. Forester's stock is currently at $31.00. Its stated book value is $29.00. But given the land appreciation is not accounted for on its balance sheet, we think the “at market” book value is closer to $32.00. For this year, we think Forestar earns $4.00 per share. With 150% growth, this means that we think Forestar could be earning $10.00 in five years. Assuming a compounding growth rate of 20%, this means that the book value should be approaching

$70.00 at that time. We believe that should amount to a healthy five-year return without a lot of worrying about valuation five years from now, as these stocks historically trade over 1x book value at some point every twelve months.

We would finally note that Forestar is barely followed by the street. Only four analysts follow it, three of which appear to do so due to the legacy of following DR Horton, making it a very misunderstood stock. While the market value is $1.5 billion, the tradable float is only about $500 million due to DR Horton's control position. We would also note that our internal trading models could have us trading around the position depending on volatility, although our preference would be to hold this stock for a five-year triple!!!

We continue to see good opportunities in the market. There are a lot of good companies that are still in recovery mode with stocks broadly flat over the last two years and small caps still down 20% from their highs. In the bond world, 8%+ yields can still be found even with 10-year government bonds hovering around 4%. With the next move being a rate cut, and the economy seemingly stable, we feel very good about the secular trends underlying our portfolios, and the valuations look attractive.

We reserve the right to change our mind!

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