Consorcio Ara and The Coming Mexican Housing Boom
Why Ara Might Be the Most Undervalued Stock in North America

Consorcio Ara (Mexico: ARA) trades at a ludicrous 38% of book value and 28% of true market value without having any leverage. Despite a horrific Mexican economy marred by COVID, Ara generated a ton of free cash flow and trades at a remarkable 15% free cash flow yield on trough earnings.

While Ara has a sterling 45-year business reputation, local Mexican investors have been frustrated by the company's ultra-conservative stance around debt, balance sheet and buybacks. But that may soon begin to change as the company just re-instituted a dividend and with its massive land bank has many ways to return capital to shareholders.

But the bigger opportunity is that the company is sitting on a massive land bank while an emerging housing shortage develops in Mexico. Last year, the country built a mere 158,000 new homes and apartments. For a country with 129 million people, this is an absurdly low number. Consider that with just 3 times the population and half the population growth, the U.S. built 1.5 million new homes and apartments last year. As we have learned in the U.S., it doesn't take many years before a lack of new home construction leads to a massive bull market in housing. It is unsustainable for Mexico to build so few homes, especially when S&P Global estimates there is a current shortage of almost 10 million Mexican homes.

Adding fuel to the fire is that the Mexican economy is also poised for a massive snap back. It is fascinating to think that any American stock that is even remotely connected to a return to normal post-COVID is at near or all-time highs, but many Mexican stock valuations remain depressed. Exports to America are 30% of Mexico's GDP, so Mexico should be a prime beneficiary to a potentially red-hot American economy this summer.

Considering its net cash position, its cash flow even in the worst economic conditions and its absurdly low valuation, Ara might just be the most undervalued publicly traded stock in North America. And this valuation exists right before the Mexican housing market and economy ramps back up.

Ara's Vertical Integration of a Land Bank, Home Developer and More

Ara is one of the largest publicly traded home builders in Mexico and is still run by the brothers, Mr. German Ahumada Russek and Mr. Luis Felipe Ahumada Russek, who founded the company 45 years ago.

The company has been and continues to be ultra-conservative with its balance sheet and its operations. One example is that Ara is vertically integrated. They not only own land and build houses, but they own 13 concrete production plants for their own use after being hurt from concrete pricing years ago.

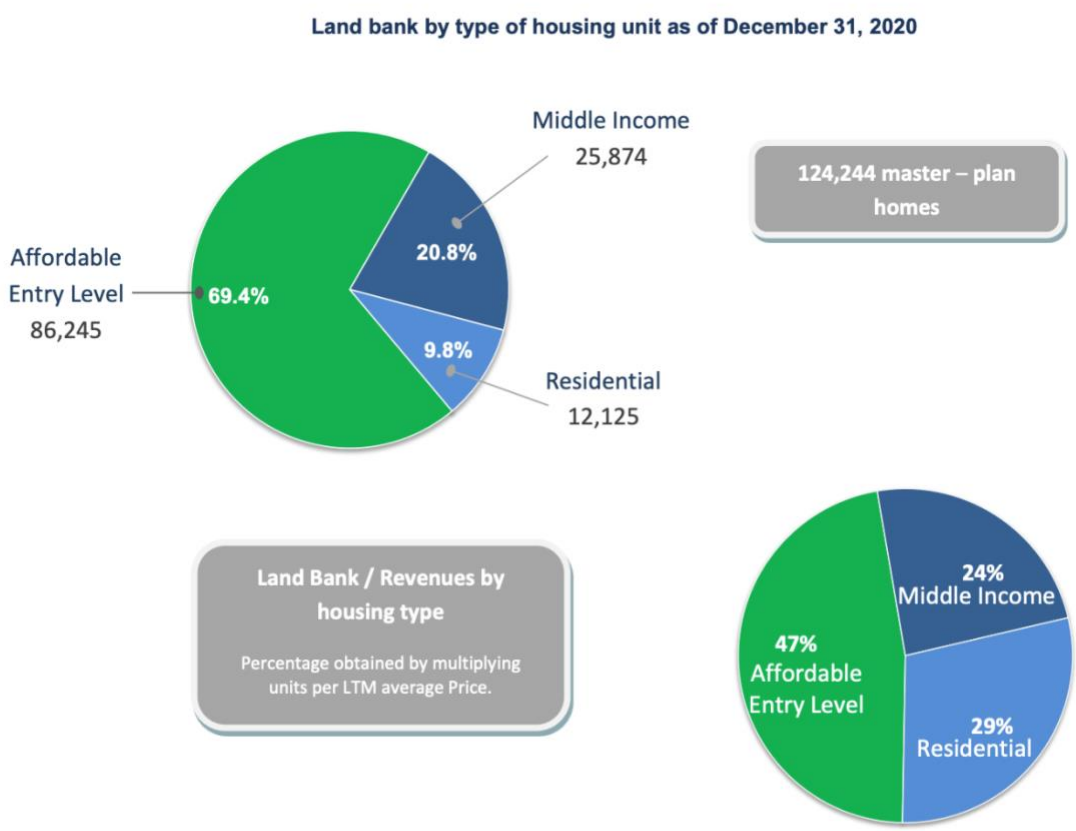
Ara has accumulated a substantial amount of land in the past few decades.

The table and map below show the geographic distribution of ARA's land bank:

State	Units	%
State of Mexico	38,178	30.7
Quintana Roo	34,431	27.7
Guanajuato	7,130	5.7
Jalisco	6,927	5.6
Guerrero	6,143	4.9
Puebla	6,063	4.9
Baja California	4,986	4.0
Hidalgo	4,693	3.8
Nayarit	3,099	2.5
Veracruz	2,790	2.2
Nuevo León	2,611	2.1
Morelos	1,337	1.1
Sonora	1,082	0.9
Subtotal	119,470	96.2
Others (5 states)	4,774	3.8
Total	**124,244**	**100**

Consider that as of the end of the year, they have enough land to build over 124,000 units. That compares to the 6,520 units they sold last year.

Most of the units in backlog belong to entry level housing (US$18,600 to US$28,700) or middle income (US$28,700 to US$62,500).



One additional note: the company's land bank includes 23.7 million square feet of space set aside for non-housing development, such as retail properties, tourist resorts and industrial zones.

Great Management Negotiated a Challenging Decade

The past decade has been a challenging one for Mexican homebuilders. First, an influx of US private equity backed home builders into the Mexican market led to an oversupply, which ended badly with several of these companies going bankrupt. Then the Mexican government removed subsidies they had in place for new home buyers. The final straw was COVID which hit the country hard, especially the tourist areas. 22% of Ara's revenue in 2019 came from Playa del Carmen and Acapulco.

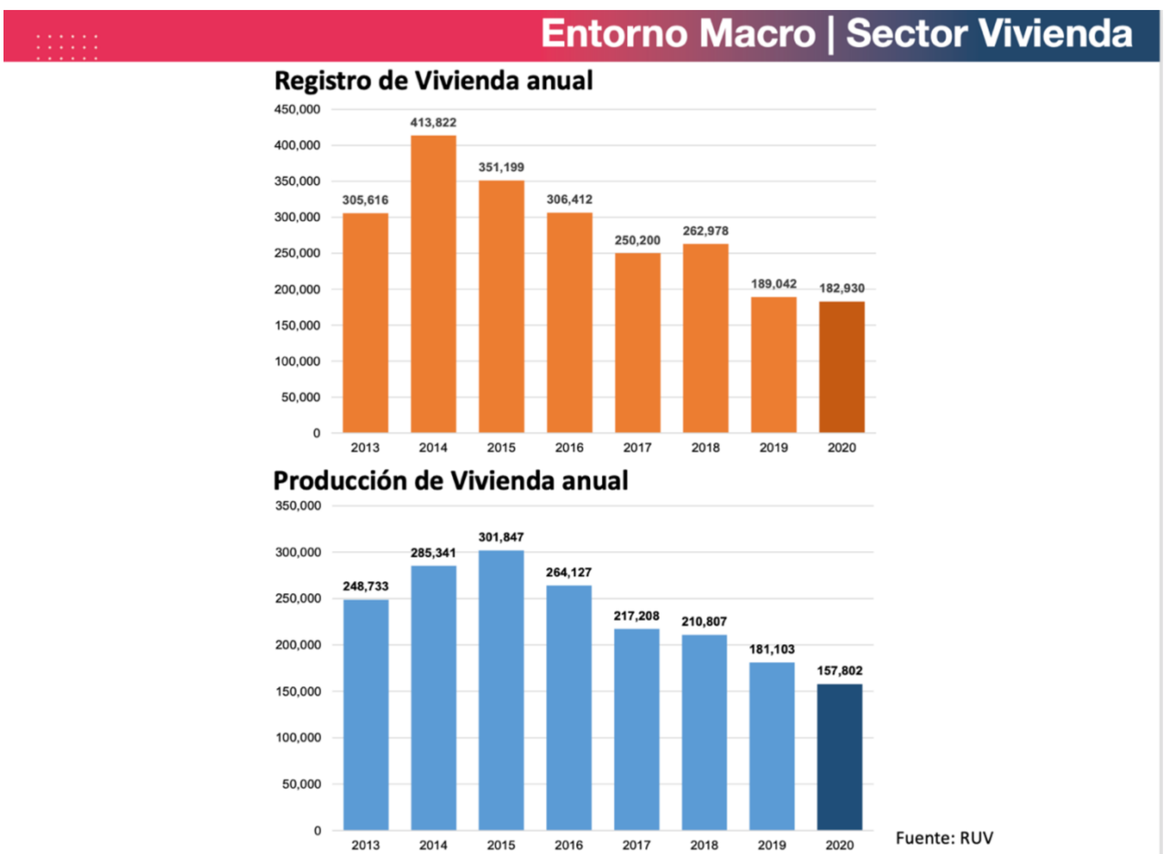
Mr. German Ahumada Russek and Mr. Luis Felipe Ahumada Russek have charted their own course not only during the past decade, but also their 45-year history. They have successfully navigated crisis after crisis and kept growing the company's book value while keeping the company profitable. It's been quite an achievement considering what has occurred during that time.

But while they are admired and respected in their industry, local investors have become frustrated with management's ultra-conservative stance, and the lack of any operating leverage or substantial buybacks. My sense is that local investors have basically abandoned the stock and no one outside of Mexico even knows the company exists.

The Coming Mexican Housing Boom

While Ara may be spectacularly cheap, why should investors care? And why will the stock's valuation change? The biggest reason is that Mexico is in dire need of new housing. Housing production is half of what it was in 2015.

See the below charts (the first is permits, the second is actual production of houses):



According to S&P Global, in 2020 Mexico's housing starts and inventory levels reached a 10-year low. “The country continues to grapple with a housing shortage of about 9.4 million units, while population grew about 1.2% annually in the past five years. According to Mexico's National Institute of Statistics and Geography, **half of the country's population was 29 years or younger in 2020.** These trends bode well for the homebuilder sector.”

(I recommend you read this S&P Global report: https://www.spglobal.com/ratings/en/research/articles/210217-for-mexico-s-housing-sector-recovery-remains-elusive-11828988)

After years of underinvestment in housing in the U.S., prices are surging and there are few homes available to buy. Mexico is on the same trajectory. You can’t have home production cut in half when demand is rising for very long.

What is fascinating is that we see evidence of this in Ara’s most recent numbers: home prices are rising and so are margins. Consider that while some of this is related to entry-level home production falling, Ara is clearly seeing much higher prices and higher margins. And this is despite a plunge in housing. The following quotes are from their latest quarterly report:

In Q4 “a total of 1,781 homes were sold, a reduction of 19.9%, and the average price was P$834,000, up 10.3%.” Part of this was mix, the company sold a higher percentage of higher priced homes. But what is fascinating is despite the recession and the hit to the economy Ara’s Affordable Entry-Level homes rose 8.5% in price. So, mix was one issue, but the dire shortfall in entry level homes is driving prices higher as well.

The company also reported that “EBITDA was P$207.7 million, an increase of 9.9%, and the EBITDA margin was 13.4%.”

You don’t normally see a 35% reduction in units, but pricing and margins going up. That is your sign that there are emerging shortages of houses in Mexico.

Incredible Value Inside Ara Includes Attractive Shopping Malls

Ara’s value extends beyond its massive residential land and commercial bank but also includes shopping malls.

From ARA:

“ARA has a unit devoted to developing, managing and marketing shopping malls. These shopping malls are strategically located in areas of high demographic growth potential, typically inside or close to ARA’s housing developments, serving as a major source of added value for those developments.”

These shopping malls are very attractive because these are not the type of shopping malls that will be disrupted by ecommerce anytime soon. These malls are more affordable shopping along the lines of Ross Store and other budget type shopping. The occupancy rate remains 95.4% and NOI while it fell 32% still was over P$280 million pesos in 2020 and that’s during a pandemic and a recession.

What is fascinating is that Ara used the decline from COVID to expand its largest mall Centro Las Americas by 40%, spending P$850 million pesos on the almost complete expansion. Earnings from the shopping mall group should explode higher due to not only a post-COVID return to normal, but the big expansion at Centro Las Americas which will now have over 85,000 square meters (almost 1 million square feet) of gross leasable area.

Ben Graham Would be Proud to Invest at This Valuation

ARA's stockholders' equity is approximately P$10.95 per share (Fully diluted share count was 1,261,482,463, as of December 31, 2020) or P$13.82 billion as of December 31, 2020. That means at Ara's current P$4.30 share price it trades unlevered at 38% of book value. But even book value may not be the proper way to value Ara, as the value at which the land is carried on the books is at least ten years old. So, the true value is probably much higher and I believe it to be north of P$15 per share. This for a company that has net cash on its balance sheet and has consistently increased book value. And if you look, they have made money regardless of the environment, including during COVID.

Return of Capital Potential

Due to the uncertainty of COVID in 2020, the company suspended its dividend, but recently announced that they are reinstating an annual dividend of P$0.1585, which is about a 4% yield.

As of December 31, 2020, cash stood at P$3.10 billion, which represents almost 60% of the company's market cap. Add this to the massive land bank and the company is dramatically overcapitalized.

There are several ways the company could add significant value to shareholders.

First, while the company has a buyback in place, the pace has been very slow, amounting to only P$66 million worth in 2020. Though this was almost double 2019's pace, the company could always increase the rate at which they buy back stock. Any shares bought are the equivalent of Mexican land at prices 75% less than they are now and are incredibly accretive to shareholders. And this right before a looming Mexican housing boom.

Another way would be for the company to sell some small amount of residential land, or the commercial tracts or its shopping malls and issue a special dividend to shareholders.

Finally, the company could signal that it will increase its dividend above its current rate. The company's free cash flow is much greater than 4%, so there is plenty of room for the company to increase its annual dividend.

Risks

The most obvious risk is political. This is Mexico and there is plenty to worry about politically. Political corruption, a leftist President as well as crime and violence are serious issues. The positives here is that Ara has weathered 45 years of every kind of cycle imaginable and there is no question that Mexico needs more home building. Finally, I would say that in light of recent tensions with China, more than ever Mexico is strategically important to America and it is unlikely that the U.S. will let Mexico slip into chaos. This article is a nice summary of how important Mexico is to the U.S.:

https://mindsetvalue.substack.com/p/worried-about-chinaus-relations-buy

Inflation and especially hyperinflation is always a worry, but with land representing such a large percentage of the book value, investors should be protected and might even benefit.

Finally, the biggest risk is that nothing really changes, the housing shortage continues, Ara continues to make money, but there never is a big housing boom and more importantly neither the dividend nor buyback is ever increased. Even in this scenario, the stock is so undervalued, it is hard to imagine losing money.

Summary

Ara is so fundamentally undervalued that if anything positive happens, the stock has enormous upside. If it just traded to book value, the stock would increase 162%. But the real upside is if the company gets more aggressive with its buy back right as the Mexican housing market goes vertical. In that scenario, Ara could go up multiples of its current share price as profits soar and the company could start to trade at a premium to book value.

For more information here is the link to Ara's corporate presentation:
https://consorcioara.com.mx/data/images/consorcio_presentacion-corporativa-march-2021.pdf