

**Building Materials Holding Corp.**  
**BMHC - \$91.25 – NasdaqNM**  
**New Recommendation**

**Recommendation: Sell Short**

**Reasons For Short Sale Recommendation**

- Ending of housing mania in their “hot” markets.
- Serial acquirer of cyclical low margin mom and pop subcontractors to homebuilders.
- Results appear strong on the surface but there are many red flags underneath.
- Tangible book value declines quarter over quarter despite growth in net income.
- Cash flow from operations is positive yet free cash flow after acquisitions is negative.
- Too much of cost of acquisitions are allocated to goodwill.
- Acquires businesses that have lower margins than their existing business?
- Front-loading charges of acquired businesses?

**Financials**

52 – Week Low 11-5-2004	\$28.65	<b>Book Value</b> (mrq)	<b>\$30.42</b>
52 – Week high 10-4-2005	\$99.19	Diluted Earnings/Shr (ttm)	\$7.91
Daily Volume Avg.	538430	Diluted Earnings/Shr (mrq)	\$2.81
52 – Week Change	204%	Sales/Shr (ttm)	\$189.19
Market Capitalization	\$1.25B	Cash/Shr (mrq)	\$3.52
Shares Outstanding	14.24M	Price/Book (mrq)	2.89
Float	NA	Price/Earnings (ttm)	11.13
Profit Margin (ttm)	<b>4.37%</b>	Price/Sales (ttm)	0.46
Operating Margin (ttm)	8.07%	Revenue (ttm)	\$2.63B
Return on Assets (ttm)	14.23%	EBITDA (ttm)	\$236.71M
Return on Equity (ttm)	30.97%	Income to common (ttm)	\$115.07M
Current Ratio (mrq)	1.918	Shares Short 4-8-05	1.75M
Debt/Equity (mrq)	0.626	% of Float Short	12.40%
Total Cash (mrq)	\$50.16M	Short Ratio	4.1

(ttm) = Trailing 12 months, (mrq) = Most recent quarter, M = Millions, B = Billions, m = Thousands

## Business Description (10K)

Building Materials Holding Corporation provides building products and construction services in the United States. It operates through two segments, **BMC West** and **BMC Construction**. BMC West markets and sells building products, and manufactures building components, such as lumber, millwork, floor and roof trusses, and wall panels. It also provides construction services to builders and contractors. BMC Construction provides framing, installation, and other construction services to production homebuilders. The company was founded in 1987 and is headquartered in San Francisco, California.

- **Turnkey Construction Services.** For high-volume production homebuilders, houses are built on-site, using integrated services that include labor and risk management, materials procurement, component manufacturing, and in certain markets, skilled labor crews that pour foundations, frame, set and anchor wood or concrete block walls, fasten roof trusses and sheath roofs, as well as install total plumbing and HVAC systems.
- **Component Manufacturing.** Roof trusses, floor trusses and wall panels are designed and manufactured. In certain markets, the high-throughput needs of production homebuilders are served with dedicated component manufacturing.
- **Materials Handling.** A broad range of building materials is supplied. Procurement, handling and distribution are streamlined, providing customized packages sequenced for job site requirements. On-time delivery is coordinated with a fleet of more than 2,000 handling and delivery vehicles.
- **Millwork Installation.** Assembly, delivery and installation of pre-hung doors and windows, stairs, custom cabinets, and interior and exterior trim.
- **Value Engineering.** Builders' plans are analyzed with recommendations to minimize materials usage, reduce construction cycle time and improve the quality of the finished home.

BMHC by revenue is half building products distribution (Products) and half construction services (Services). In Products, 55% of total revenue is commodity wood products with lumber 30% of the total.

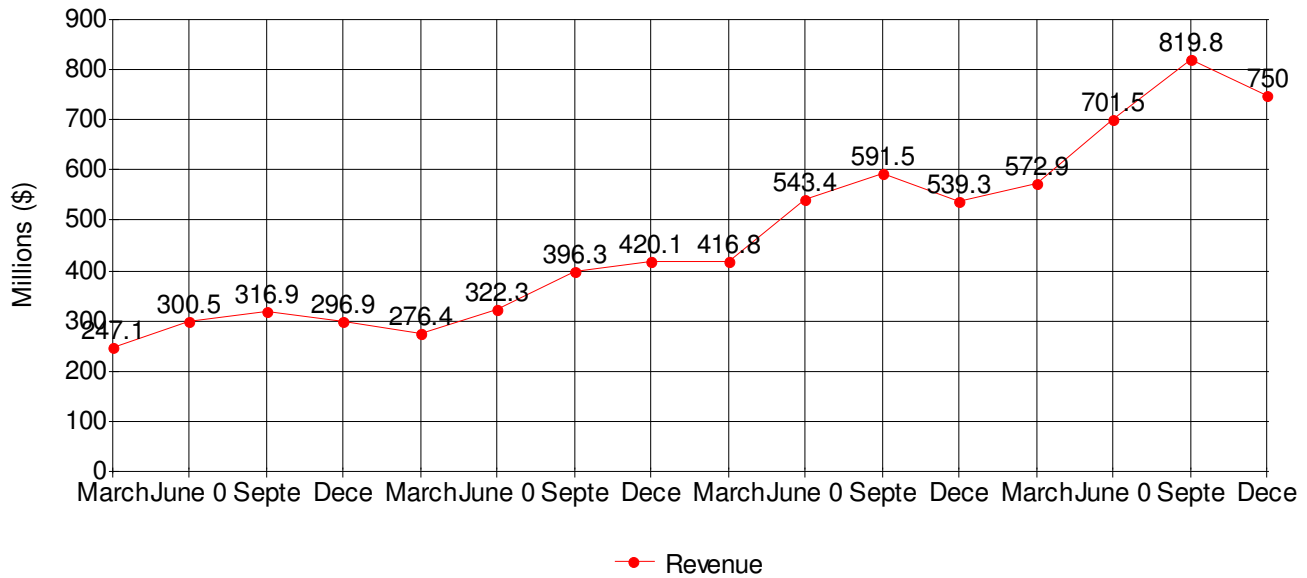
## Analysis

The bull story on BMHC is straightforward. There is no housing bubble and the fundamentals are great. Revenue and earnings are growing nicely. The company has positive cash flow from operations. It is currently trading at a reasonable 10.5 times next years earnings estimate of \$8.35. Even though earnings per share are estimated to decline 7% next year, the stock is still attractive. There is no housing bubble. For the quarter just ended September 30, 2005, revenue increased 39% from \$591.5 million to \$819.8 million and EPS increased 129% from \$1.29 to \$2.81.



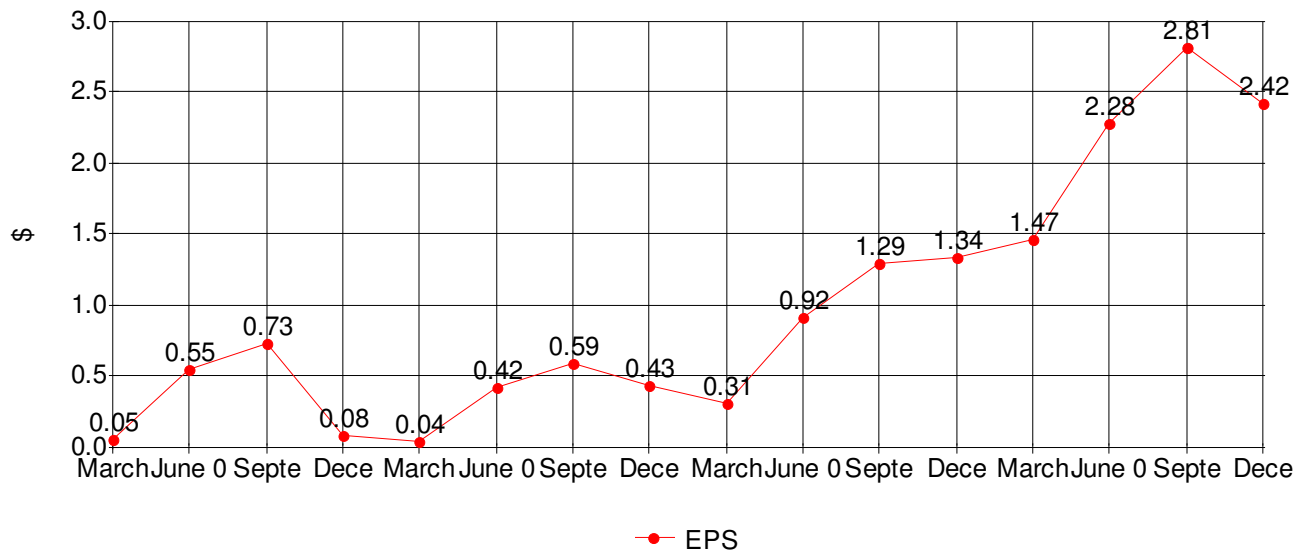
### BMHC Revenue

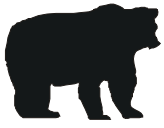
March 2002 To December 2005 Est.



### BMHC EPS

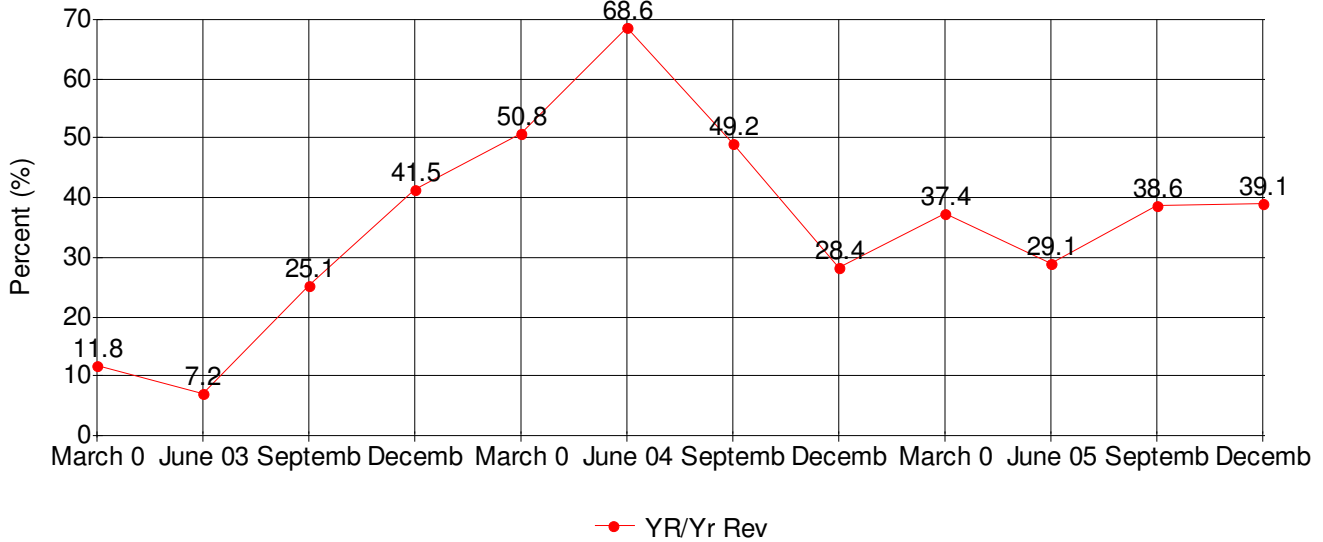
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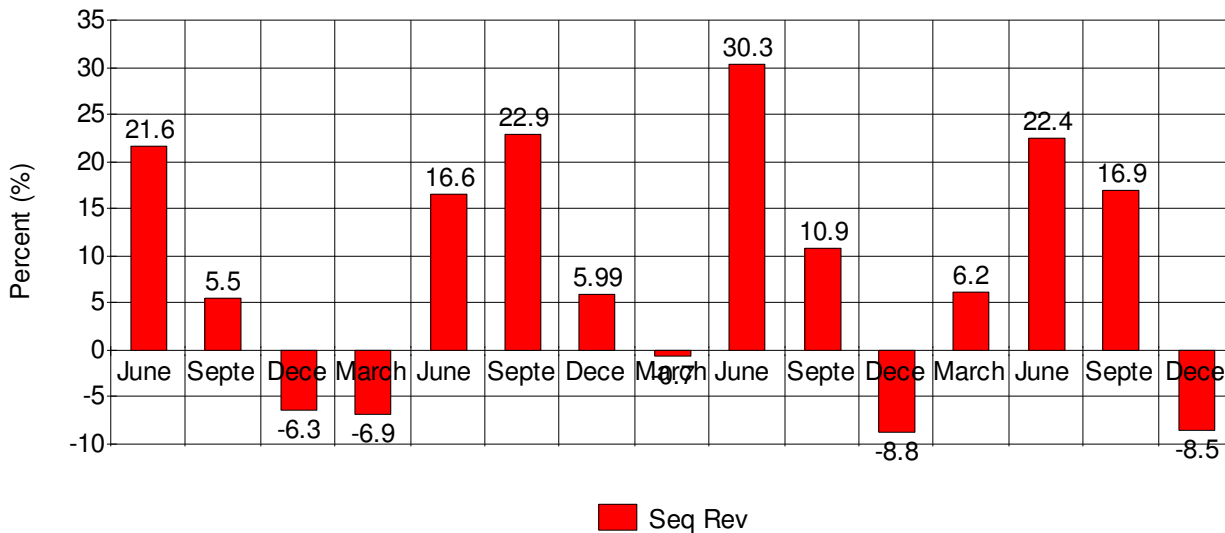
### BMHC Revenue Growth Rate %

Year Over Year



### BMHC Sequential Revenue Growth Rate

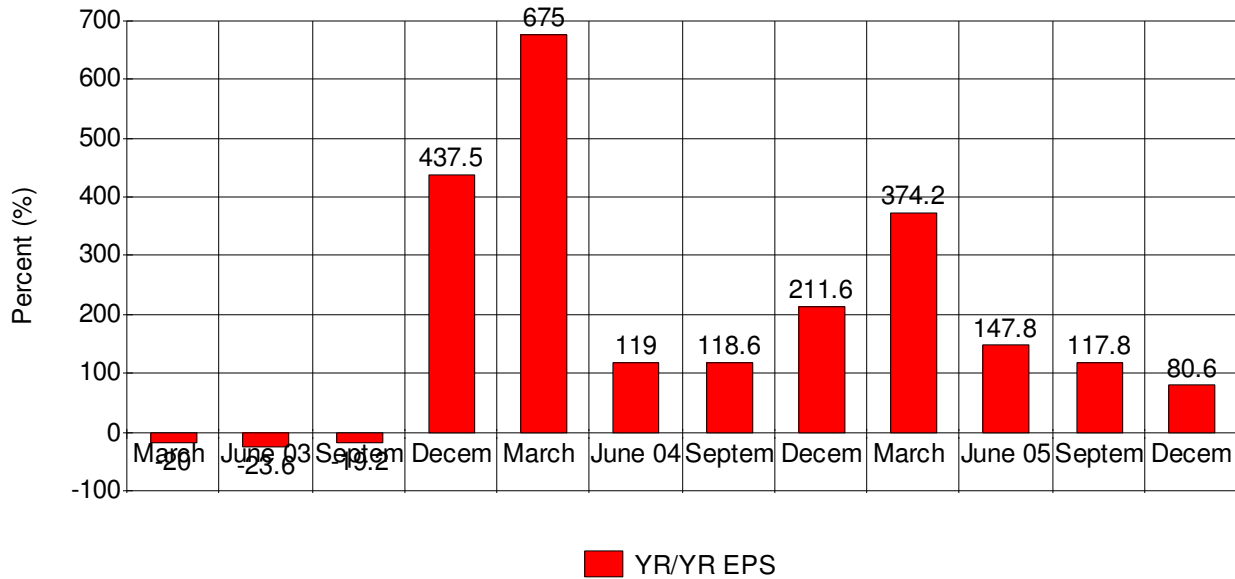
June 2002 To December 2005 Est.





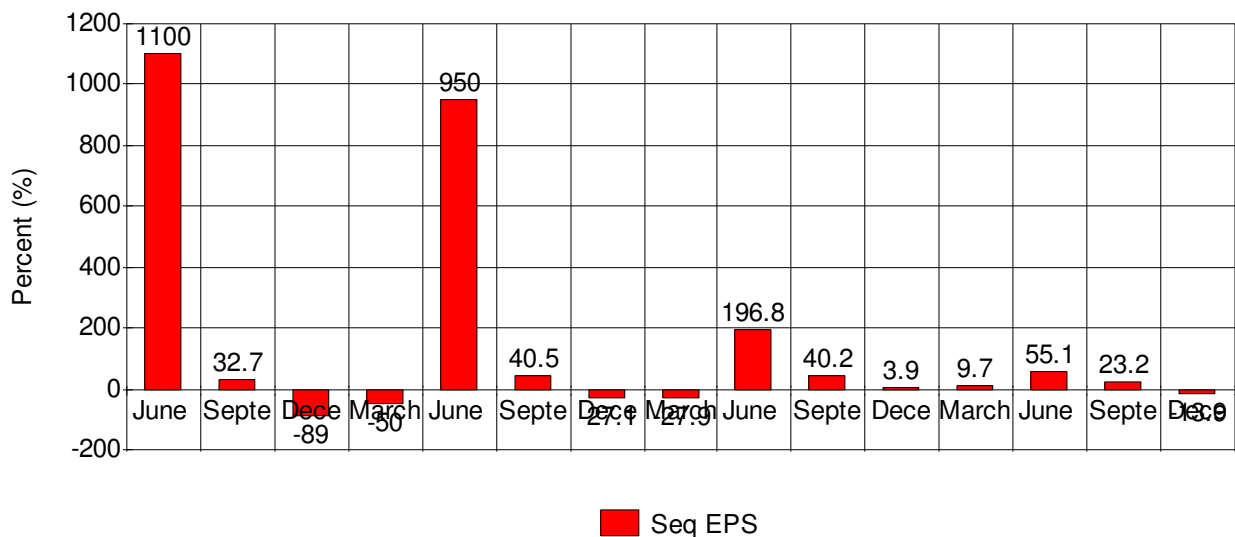
### BMHC EPS Growth Rate

Year Over year



### BMHC Sequential EPS Growth Rate

June 2002 Top December 2005 Est.





## Ending of Housing Bubble?

In our opinion there has been a housing bubble, at least in certain parts of the country. Some markets have seen more of a boom than others. We feel that the markets that BMHC operates in are much more likely to suffer from a slowdown in the housing boom. The short story in BMHC comes from the construction services business.

Construction services (foundation, framing, plumbing) accounts for about 10-15% of the total cost of a new home. BMHC has 26 construction services locations. 23 of those locations, or **88% of the total, are located in AZ, CA, FL, and Las Vegas**. In other words, the vast majority of their locations are considered to be in currently “hot” markets. Of course, what is hot today can be a bust tomorrow. If you have been to Las Vegas lately you can see the development of houses literally as far as the eye can see in some places. There are row after row of identical houses out in the middle of the desert. In California and Las Vegas there are no laws against similar houses in a development. So it is common to see an entire subdivision with only 3 home plans all built by the same builder. It is very difficult to differentiate your house from your next-door neighbors house, since it is basically the exact same house. That means that the market value of all the houses rises and falls together. If the housing boom ends and prices decline, all of the houses will decline in price. In Wisconsin, we have laws against similar houses in a subdivision to prevent this kind of event happening and to broaden the appeal of the neighborhood with many different styles of homes.

## Serial Acquirer

Starting three years ago, BMHC entered the construction services business by rolling up acquisitions. These were mostly subcontractors to homebuilders. This is traditionally a low margin business run by local mom and pop operators and is a very cyclical business.

This services business has increased BMHC operating margins up to 8.7% in Q2 and 9.2% in Q3. From services, gross margin dollars are up over 130% in the first half of 2005, and now account for 40% of total gross margin and for the majority of the growth in operating income. We feel that this is unsustainable, but that the market is extrapolating the current results going forward. Almost half of earnings per share are dependent on the “hot” markets in Las Vegas, AZ, FL and CA. BMHC is concentrated over a small number of developments and has benefited by being able to raise prices for its commodity construction services during periods of home shortages in these areas.

Over the long term, this has been a 3-4% operating margin business. The mom and pop businesses that BMHC acquires are low value added subcontractors that do jobs locally with high fixed labor costs. BMHC acquires service businesses for 3-5 times EBITDA. These are not very valuable businesses. In 2004, BMHC acquired about \$350M of revenue and booked \$8M in goodwill. **It is very important to note that BMHC has only been operating these businesses during the bubble environment of the last three years! These are high fixed cost businesses that will deleverage when pricing softens.**



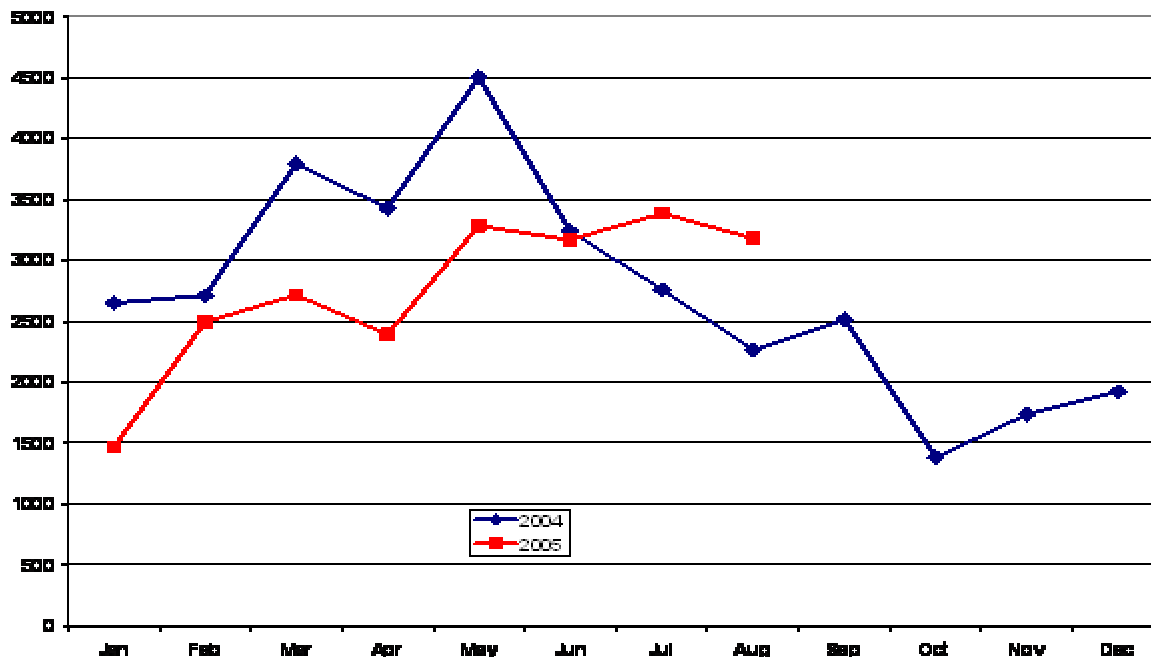
BMHC claims that they create synergies by rolling up businesses in one area and then eliminating on site managers. While this is true, it also makes margins dependent on a few markets of high volume housing construction. The most recent acquisitions have all been in services and have all been in BMHC's 4 most concentrated markets.

Because of over heated demand in their few concentrated markets, BMHC has been able to hold homebuilders hostage and demand inflated prices for their services. Homebuilders have responded to this price gouging by spreading construction activity over more areas and increasing the number of houses being constructed. **We calculate that backlogs at homebuilders have to continue to grow at near 15% for these contractor margins to last. Not only is it possible that this will not continue to occur but we believe that it is likely that the backlogs could instead decrease!**

**It is also important to note that housing prices do not have to decline to affect BMHC's earnings in a negative fashion.** BMHC's EPS could decline by 30% or more if pricing for subcontracting in high volume home building slows in Las Vegas and/or Phoenix. We can track housing permits to get a feel for future home construction.

There were 3,179 permits pulled in the Las Vegas metropolitan area in August, bringing the annual total to 22,069. **This is a year-to-year decrease of 3,266 permits, or 14.8 percent.** The average number of new home permits that have been pulled monthly in 2005 is 2,758. This is 408 less than the 2004 average per month during the same time period.

### NEW HOME PERMITS - 2004 - 2005



## Net Income up, Tangible Book Value Down

Another red flag for BMHC, as of September 30, 2005, tangible book value declined \$29.5 million from the June 2005 quarter to \$254.5 million from \$284.0 million despite net income increasing \$41 million before about \$2.1 million in dividends. For the 9 months ended September 05 tangible book value increased only \$20.8 million despite \$96 million in net income.

BMHC CFO Bill Smartt claims that the decrease in tangible book value is because the businesses acquired had negative book value. He says the value is not in the hard assets but in the relationships and market position.

## Cash Flow

Cash flow from operations and free cash flow (cash flow less cap-ex) are positive and up from the previous year. However, FCF after cash spent on acquisitions is negative. On the surface cash flow from operations seems healthy, but in the same quarter a large acquisition is made. After the acquisition FCF is negative.

Trailing 12 Month Cash flow	<u>Dec-03</u>	<u>Mar-04</u>	<u>Jun-04</u>	<u>Sep-04</u>	<u>Dec-04</u>	<u>Mar-05</u>	<u>Jun-05</u>	<u>Sep-05</u>
operating income	40.4	48.9	65.1	84.6	108.1	137.8	172.2	212.9
net income	19.9	23.5	30.5	40.6	53.9	70.9	91.6	115.1
CFO	12.5	1.8	(16.9)	11.0	33.7	55.7	136.0	163.3
FCF (CFO-cap ex)	(3.4)	(16.2)	(39.7)	(16.8)	6.0	24.7	105.5	128.6
FCF (CFO-cap ex-acquisitions)	(33.7)	(27.1)	(51.8)	(43.7)	(16.7)	1.2	60.4	(13.2)
FCF (CFO-cap ex-acqu +proceeds)	(17.0)	(17.3)	(42.3)	(28.1)	(4.4)	10.2	68.6	?

Qrtly cash flow	<u>Jun-04</u>	<u>Sep-04</u>	<u>Dec-04</u>	<u>Mar-05</u>	<u>Jun-05</u>	<u>Sep-05</u>
CFO	(13.8)	32.0	23.3	14.2	66.5	59.3
Cap-ex	(9.3)	(8.6)	(4.7)	(8.3)	(8.9)	(12.8)
Acquisitions	(0.8)	(16.1)	(1.8)	(4.7)	(22.4)	(112.9)
proceeds from sale of PPE	1.1	7.0	0.8	0.1	0.2	?
Proceeds from sale of business	-	-	-	-	-	?
FCF (CFO-cap ex)	(23.1)	23.4	18.6	5.9	57.6	46.5
FCF (CFO-cap ex-acqu)	(24.0)	7.3	16.8	1.2	35.3	(66.4)
FCF (CFO-cap ex-acqu +	(22.9)	14.3	17.6	1.2	35.5	?



## Too much of cost of acquisitions are allocated to goodwill

In the quarter just ended Sept 05, of the \$113 million was spent on acquisitions, \$69 million (61%) was booked to earnings friendly goodwill.

	Sept 04	Dec 04	Mar 05	Jun 05	Sep 05	Change from Dec 04
Goodwill	81.1	80.3	82.6	91.6	160.7	80.4
qtr/qtr change in goodwill		(0.8)	2.3	9.0	69.1	
Cash spent on cap-ex	(8.6)	(4.7)	(8.3)	(8.9)	(12.8)	
Cash spent on acquisitions	(16.1)	(1.8)	(4.7)	(22.4)	(112.9)	

## Acquires businesses that have lower margins than their existing business

The margins on the businesses acquired are significantly lower than margins from its existing business. The margins acquired into BMC West for the 1<sup>st</sup> 9 months of 2005 were 1.2%. Compare that to the 10.1% margin on its existing business. **Why is BMHC acquiring businesses with far lower margins?** This does not make much sense to us, and **leads us to believe that BMHC is front loading charges into the acquired businesses.** This is what Tyco did. Why else would these margins be so much lower?

<b>BMHC</b>	<b>Acquired</b>		<b>Existing</b>	
<b>Margin on Activities:</b>	<b>3 mos</b>	<b>9 mos</b>	<b>3 mos</b>	<b>9 mos</b>
<b>acquired vs existing</b>	<b>3 mos</b>	<b>9 mos</b>	<b>3 mos</b>	<b>9 mos</b>
<b>(\$ mlns)</b>	<b>Sep-05</b>	<b>Sep-05</b>	<b>Sep-05</b>	<b>Sep-05</b>
<u>BMC Construction</u>				
revenues	116.8	193.8	285.6	754.5
operating income	11.7	16.2	35.4	96.2
margin	10.0%	8.4%	12.4%	12.7%
<u>BMC West</u>				
revenues	0.093	19.055	417.335	1,126.945
operating income	(0.002)	0.236	43.646	113.313
margin	na	1.2%	10.5%	10.1%

## Conclusion

We believe that BMHC is currently trading at close to peak valuation. It is currently trading at 10 times this years EPS estimate of \$9.00. EPS is estimated to decline 7% next year in 2006. We believe that the real estate good times have peaked and are about to slow at best and burst at worst. The last 3 years are about as good as it gets in the housing market. Low interest rates, high demand, excess liquidity, housing ATM-refinancing, stagnant stock market, new interest only mortgages, and low energy prices. Everything was perfectly bullish for housing prices which always spurs supply.

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We believe all that is changing. The Federal Reserve has just raised rates for the 12<sup>th</sup> consecutive time, with more to come. Easy refinancing at rates below 5% are long gone. Energy prices are up sharply from one year ago. Minimum payments on credit cards just went up. The consumer is overextended. One third of all new mortgages originations are interest only for the first three years before payments skyrocket upward. The typical payment on these types of payments is \$1,200, which then jumps to \$2,000 after 3 years, a 67% increase. The only way a homeowner could afford to buy a house by using this type of mortgage is because he could not afford a regular mortgage. The plan is to then sell for a big profit after 3 years and move into a new bigger house. The problem is everybody is going to be selling at the same time, which will increase supply and lower prices.

American Standard just had a bad earnings result. There are a lot of “tells” that the housing market is/will be cooling down. We believe that a slowdown will hit the most speculative markets the hardest. These are exactly the markets that BMHC operates in. It is very possible that EPS at BMHC could decline back to \$5 or less in the future. Most homebuilders trade at 6-8 x forward earnings versus 10 times for BMHC. It would not be a stretch to see BMHC also trade at 7 times earnings, especially if EPS is declining. If EPS only declines 20% from \$9 to \$7.20, that would equate to a valuation of around \$50 per share.

We have a price target of \$50 to \$60 within 12 months. Sell.