LGI Homes, Inc.

NASDAQ: LGIH

Analyst: Kevin Akbaraly
Sector: Consumer Discretionary

BUY

Price Target: $21

Key Statistics as of 3/25/2015

Market Price:	$15.20
Industry:	Homebuilders
Market Cap:	$301.7 M
52-Week Range:	$12.21 - $22.21
Beta:	N/A

Thesis Points:

- The market has overreacted regarding the impact of the energy sector
- The market has not taken into consideration the new mortgage rules announced in late 2014
- LGI Homes' stock price is currently undervalued compared to its peers

Company Description:

LGI Homes was founded in 2003 and operates as a homebuilder. The company designs, constructs, markets, and sells homes in the U.S. by focusing particularly on entry-level homebuyers. LGIH launched its Terrata Homes brand division in November 2014 with the objective of expanding its business into a higher-price range bracket segment with expected sales prices of $350,000. The homebuilding company also started its geographic expansion from its Texas-based operations into Arizona, Florida, Georgia, New Mexico, South Carolina and Colorado markets. As of December 2014, the company has sold 8,500 homes since inception and is headquartered in The Woodlands, Texas.

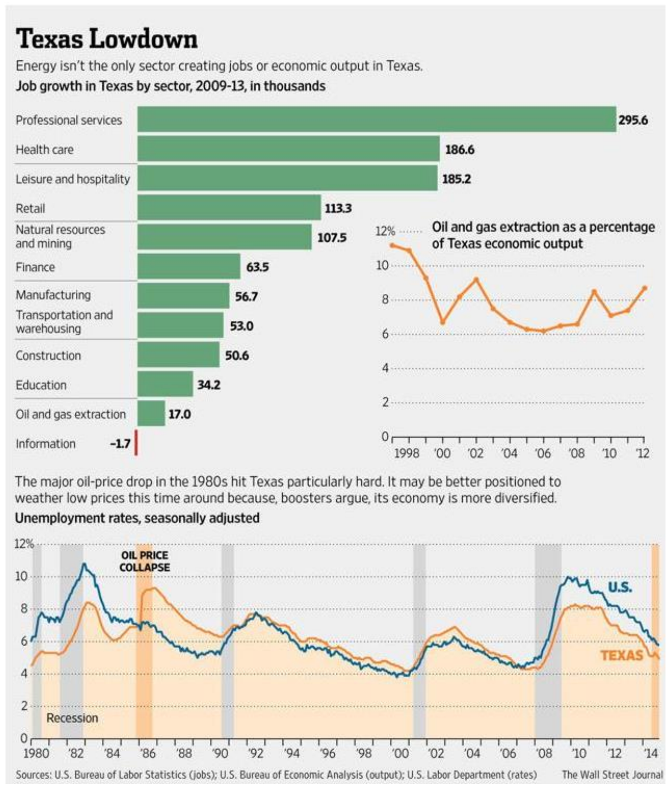
Thesis

LGI Homes is a homebuilding company based in Texas with $388M of revenues. The company focuses on entry-level homebuyers and has seen high growth coupled with high margins relative to peers over the past two years. However, the market seems to have overestimated the impact of declining energy prices on LGIH's expected revenues, and has not taken into consideration the new mortgage policies announced in late 2014. For these reasons, LGI Homes is currently undervalued compared to its peers, creating a good opportunity for investors to enter into a long position. A BUY is therefore recommended on LGI Homes with a 1-year target price of $21.00, representing a 38% upside potential from current market price.

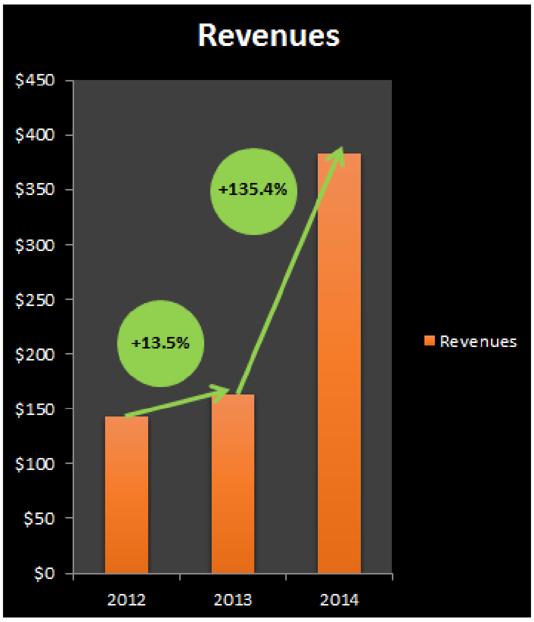
Overreaction over the Energy Sector in Texas

LGI Homes is headquartered in Texas, where the majority of the company's operations are concentrated. Texas is qualified as highly dependent on the energy sector due to its activities related to oil and gas extractions. With 14.2 million barrels extracted daily over Q3 2014, the U.S. remains the biggest worldwide oil producer since 2012, followed by Saudi Arabia (11.7 million barrels per day) and Russia (10.5 million barrels per day) with Texas accounting for the largest producing state within the U.S. Oil prices have dropped more than 50% since its mid-2014 level, and some companies operating within the sector are expected to struggle for survival in the near future. Following this trend, the market anticipates a reduction in revenues generated by the sector, followed by a cut-off in production, which in turn could lead to potential lay-offs and could worsen the situation even further. As a result, the market is anticipating lower demand over all durable goods within Texas because households are expected to see a reduction in their disposable incomes. By comparing LGIH's stock price to crude oil prices over the past two years, it is clear that LGIH's market price has been highly impacted by the drop in oil prices.

The impact that oil prices has had on LGIH over the past 6 months can therefore be a good opportunity for investors if the market's reaction turns to be overestimated. In order to rationalize the energy sector's impact on the company, we need first to take into consideration that Texas is becoming less and less dependent on the commodity market. Texas's regional GDP totaled $138.8 billion in 2013 including $16.2 billion coming from the mining sector, representing only 11.7% of total GDP. Additionally, the number of jobs that is related to resource extraction activities accounts for less than 3% of total employment within the state. As a result, the impact the energy sector has on Texas' economy concerns only a small portion of the population that is not targeted by the company.



The last report issued by the Bureau of Economic Analysis on March 25, 2015 says that Texas is ranked second in the nation in term of population size with 27M inhabitants. The report also shows that per capita personal income increased to $45,426 in 2014, in line with the national average of $46,129. Looking at revenue growth rates over the period oil prices have been declining, LGIH has generated $92.5M in Q3 2014, representing a 13% decline compared to Q2 2014, but still 143% higher on a YoY basis compared to Q3 2013. LGIH generated $108.4M in Q4 2014 representing a 17% growth compared to Q3 2014, and 65% compared to Q4 2013. These results show that LGI Homes remained effective at selling homes during a period surrounded by uncertainties, which also shows the limited impact the energy sector has on LGIH's growth.



Finally, LGI Homes started an aggressive geographic expansion over the past two years. It should help the company lower its dependency on the Texan market in the future. In 2013, LGIH expanded its operations in Florida (Florida Division), Georgia (Southeast Division), and Arizona (Southwest Division) prior to its IPO. In 2014, the company acquired Oakmont Home Builders, Inc. and added the Charlotte market into its Southeast Division. In parallel, the company entered into the Denver Market for its Southwest Division and finally launched its Terrata Homes Division in San Antonio. The company closed its first Terrata deal during January 2015, but the management team has stated that they do not expect this segment to exceed 10% of LGIH's revenues over the year.

The company's management team believes that it could expand its business model into new markets in order to diversify its revenue sources by focusing on high-growth markets. LGIH is therefore becoming less and less dependent on Texas, and even though the majority of the company's revenues are still generated from the state, investors can expect this to change in a near future. Indeed, the company's home closings represented 84% of Texas total home closings in 2013. In 2014, this percentage lowered to only 66.8% whereas the company still managed to grow this number by 16% on a YoY basis, in Texas only. The company has already reduced the portion of its inventory that was concentrated in Texas, and as of 2014, LGIH had less than one home available for sale out of two located outside of Texas.

	Texas Segment	
	2014	2013
Home Closing	66.85%	83.98%
Home Owned	68.43%	66.97%
Home Controlled	45.24%	75.87%
Total # of Home	12,697	10,706
Inventory	43.65%	54.24%
Inventory Value	43.86%	49.84%

Sanctioned for Convertible Notes

During November 2014 LGI Homes issued $85M of convertible notes due in 2019 at an interest rate of 4.25% with a conversion price of $21.52. The market has negatively reacted to the announcement, and LGIH's stock price dropped 8.5% on the following trading day. This sanction directly relates to the dilution impact the convertible notes would have on shares held by current investors. However, the company repurchased at the same time 1M shares at a market price of $16.55. This repurchase program can partly offset the effect of dilution linked to newly convertible notes issued, and appeared to be a good investment for the company. Another reason why the market has sanctioned LGIH following this announcement is a lack of transparency regarding the use of this capital. Indeed, the company only provided little information. The company stated that the debt would be used for lands and lots acquisition in addition of other general purposes. One option for the homebuilding company could be for merger and acquisition purposes as well. As LGIH starts to be more aggressive on its geographic expansion, the company might use a portion of this capital to expand its business more effectively in other areas. Nevertheless, the issuance of debt seems to be justified regarding the company's strategy over the coming years in order to build the required inventory to expand. In addition, the company has stated that they would increase their average prices in certain areas, which in turn would help the company increase its operating margins even further. Even though the issuance of debt seems to be justified to finance LGIH's high growth, the level of debt has been substantially increased from 16% to 49.3% of total assets. On the other hand, LGIH's times interest earned ratio decreased only to 10.3 times in 2014 from 13.4 times in 2013. As a result, this new level seems to be under control, and should lower investors' concerns in coming years.

Easing of Mortgage Rules

During November 2014, Fannie Mae and Freddie Mac announced a government-sponsored program that would ease the availability of mortgages within the U.S. Indeed, the government wanted to bring more people in the housing market after it felt that the economy has recovered enough to support such a program. The largest government mortgage entities have announced that they would lower the required down payments to 3 to 5% from the previous level of 20%. However, they also stated that they would need banks and private mortgage insurance companies to support the new program in order to limit risks of default from homebuyers. This new program should reduce credit scores required for mortgage eligibility from 742 to 620. Based on 2012's data, this would result in the addition of 15% to 20% of the American population into the housing market. Due to the population targeted by this program, LGI Homes is therefore well positioned to benefit from this increase in potential customers as the company targets specifically entry-level home buyers. Additionally, due to the concerns raised by the energy sector within Texas, the market has not reacted to the announcement, meaning that investors can still benefit from current market price to enter into a long position.

LGI Homes' stock price is undervalued

LGI Homes has shown to be efficient at growing its revenues over the past years. Revenues increased by more than 135% from 2013 to 2014, with a compounded annual growth rate of 54% from 2010 to 2014 while competitors grew by 22.4% and the market retuned only 10% over the same period. The company has a strong focus on high growth markets, and expands strategically into these areas in order to increase shareholders' returns. Also, the rate at which the homebuilding company is converting renters into homeowners is increasing, showing the rising effectiveness of the company at growing the business. Moreover, LGI Homes has the highest margins amongst its competitors. Gross margins are about 27% while the average among peers is about 19.6%, followed by EBITDA margins of 11.5% compared to an average of only 6.5% for the company's peers. It might be related to the way the company acquires lots of lands, generally outside urban areas because of a cheaper price. This performance is even more impressive when we consider the fact that LGIH does not construct its homes by itself but outsources the construction process to third parties. The company has an inventory turnover of 1.5 times compared to an average of 1.0 times, meaning LGI Homes is able to convert its whole inventory into sales within only 243 days while competitors need on average 365 days. Despite all these good results, LGIH's stock price seems to lag behind the homebuilding market. Comparing the company's stock price to the S&P Homebuilders index, it is easy to see that LGIH has been left behind recently due to concerns related to energy prices.

LGIH's trailing Price Earnings ratio is 7.65 compared to an average of 20.3 over the past 2 years and 22.85 for peers. The forward P/E ratio is 5.71 times compared to an average of 12.75 times for its peers. EV/EBITDA is 11.13 times compared to an average of 20.80 times over the past 2 years for LGIH, and 19.92 times for its peers. Finally, EV/Revenues is 1.25 times compared to 2.13 times over the past two years and 1.44 times for the company's peers. Based on these multiples, we can also conclude that LGIH is significantly undervalued at the current price and should see a rebound in the near term.

Conclusion

To conclude, a BUY is recommended on LGI Homes (LGIH) with a 1-year target price at $21, a potential upside of 38% based on the current price. The valuation of the homebuilder has been made using a proforma displayed on the last page of this report. The market is currently overestimating the impact of the energy sector on LGIH's return prospect. Following investors' preoccupations, the market did not react to the announcement made by Fannie Mae and Freddie Mac on new mortgage policies. However, the new program could help the company to expand its operations geographically more effectively than expected. LGIH is expected to grow rapidly with high operating margins compared to its peers and offers investors an investment opportunity at the current market price.

LGI Homes, Inc. | **LGIH** | **Kevin Akbaraly** | **Current Price: 15.2** | **Lower Bound Intrinsic Value: $16.1** | **Lower Bound 1y-Target: $21.1** | **Dividend Yield: 0%** | **39.03%**

General Info

Sector	Consumer Discretionary
Industry	Household Durables

Description: LGI Homes, Inc. designs, constructs, markets, and sells homes in Texas, Arizona, Florida, Georgia, New Mexico, Colorado, North Carolina, and South Carolina, the United States. The company was founded in 2003 and is headquartered in The Woodlands, Texas.

Market Data

Enterprise value	$486.43
Market Capitalization	$3,068.87
Daily volume	0.32817
Shares outstanding	19.85
Diluted shares outstanding	21.20
% shares held by institutions	105.9%
% shares held by insiders	18.8%
Short interest	10.8%
Days to cover short interest	12.71
52 week high	$22.21
52-week low	$12.21
5y Beta	0.00
6-month volatility	44.03%

Peers

Symbol	NAME	Market Cap	TEV/EBITDA	P/B	EBITDA Margin	Total Debt/TEV	EBIT/Int. Exp.	Altman Z
NYSE:WCIC	WCI Communities Inc	$612.97	18.6x	1.4x	10%	40%	32.3x	2.60
NYSE:CCS	Century Communities, I	$419.96	15.7x	1.1x	11%	37%	1,400.0x	2.62
NYSE:HOV	Hovnanian Enterprises I	$518.79	19.9x	NM	6%	85%	1.3x	1.59
NYSE:BZH	Beazer Homes USA Inc	$458.90	29.5x	1.8x	4%	84%	1.0x	1.65
NYSE:MHO	M/I Homes, Inc	$571.89	12.0x	1.2x	7%	45%	6.4x	2.94
Peers' Median		**$518.79**	**18.6x**	**1.3x**	**7%**	**45%**	**6.4x**	**2.60**
LGIH		**$301.70**	**10.2x**	**1.7x**	**12%**	**44%**		**3.21**

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Lipar, Eric	Chairman and Chief	$ 550,206.00	$ 643,390.00	$ 1,470,339.00
Snider, Michael	President and Chief	$ 607,538.00	$ 1,813,697.00	$ 1,048,844.00
Merdian, Charles	Chief Financial Officer,	$ 316,889.00	$ 969,974.00	$ 638,637.00
Britton, Margaret	Chief Administrative	$ -	$ -	$ -
Eaton, Rachel	Chief Marketing Officer	$ -	$ -	$ -
Lipar, Jack	Executive Vice President	$ -	$ -	$ -

Performance

	LGIH Last	LGIH 10y Med.	Peers Last	Peers 10y Med.	Industry Last	Industry 10y Med.	All U.S. firms Last	All U.S. firms 10y Med.
ROIC	8.1%	20.4%	6.18%	-3.19%	48.90%	10.50%	11.03%	11.85%
EBITA Margin	12.2%	0.0%	6.16%	2.06%	10.02%	9.92%	13.64%	13.67%
Imputed Rev./Invested cap.	1.03	1.06	1.09	1.02	1.01	1.02	1.72	2.02
Excess Cash/Total Cash	8.18%	N/A	15.02%	26.00%	12.87%	16.04%	23.11%	18.48%
Total Cash /Rev.	8.18%	8.18%	15.02%	26.00%	13.49%	17.09%	32.95%	30.26%

Current Capital Structure

Total debt/market cap	44.43%
Cost of Borrowing	4.79%
Interest Coverage	
Debt Rating	BBB
5y Beta	0.90
WACC (based on market value weights)	8.4%

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	0.2%	0.0%	-2.7%
Last Quarter-1	2.7%	-14.9%	0.0%
Last Quarter -2	6.1%	10.2%	39.4%
Last Quarter -3	3.5%	1.8%	56.3%
Last Quarter -4	7.9%	0.0%	0.0%

Continuing Period Assumptions

Money market rate as of today	0.54%	Risk-Free rate	2.7%	LT Op. Costs/Rev	90.0%
Annual increase (decrease) in interest rates	0.10%	Op. Cash/Rev.	0.00%	LT WACC	9.8%
Yield Spread acceleration	1.2	Op. Cash/Cash	0.0%	LT Term ROIC	7.9%
Marginal Tax Rate	37.5%	LT Growth	3.0%	Growth in PPE	Equals to Maintenance

Last Guidance Mar-12-2015 **Next earnings date NM** **Last Earning Call Transcript: www.lgihomes.com**

LGI Homes, Inc. reported unaudited consolidated earnings results for the fourth quarter and full year ended December 31, 2014. For the quarter, the company reported revenues of $108.420 million compared to $65.453 million a year ago. Operating income was $11.529 million compared to $3.506 million a year ago. Income before income taxes was $111.574 million compared to $9.917 million a year ago. Net income was $7.534 million compared to $9.124 million a year ago. Net income attributable to owners was $7.534 million compared to $9.131 million a year ago. Diluted earnings per share was $0.34 compared to $0.34 a year ago. Adjusted earnings were $8.0 million, after excluding $0.5 million of non-recurring expenses, net of tax.

For the full year, the company reported revenues of $383.268 million compared to $162.796 million a year ago. Operating income was $42.371 million compared to $16.384 million a year ago. Income before income taxes was $43.079 million compared to $22.803 million a year ago. Net income was $28.211 million compared to $21.737 million a year ago. Net income attributable to owners was $28.211 million compared to $22.327 million a year ago. Diluted earnings per share was $1.33.

The company offers the following guidance for 2015. The Company believes it will have between 50 and 55 active selling communities at the end of 2015, close between 2,800 and 3,200 homes during the year, and generate EPS between $1.85 and $2.25 per share. This outlook assumes that general economic conditions, including interest rates, and mortgage availability in 2015 are similar to those in 2014,

LT convergence estimates: weights are either implied from the stability of each time-series"--i.e., median/[max.-min.], or estimated based on the "uniqueness" of its competitive power--i.e., buyers power, suppliers power, competitive rivalry, threat of substitution, and threat of new entries.

	Rev./Capital Last	Rev./Capital 10y Median	LT Imputed Growth Last	LT Imputed Growth 10y Median	LT Op. Costs/Rev. Last	LT Op. Costs/Rev. 10y Median	Unlevered Beta Last	Unlevered Beta 10y Median	TEV/Rev.	TEV/EBITDA	TEV/EBITA	TEV/UFCF
LGIH	1.03	1.06	140.3%	140.3%	87.6%	87.93%			1.8x	15.0x	15.2x	
Peers	1.09	1.02	23.7%	-9.1%	93.5%	97.27%	1.26	1.12	1.2x	17.3x	20.5x	4.6x
Primary Industry	1.01	1.02	17.4%	1.9%	90.1%	92.96%	1.18	0.91	1.4x	17.4x	21.0x	29.4x
Industry	1.45	1.49	10.7%	4.7%	89.8%	90.96%	1.15	1.14	1.2x	11.3x	14.5x	26.7x
Industry Group	1.66	1.76	10.3%	6.2%	87.2%	87.52%	1.05	1.13	1.4x	11.1x	14.0x	28.3x
Sector	2.15	2.16	6.7%	5.6%	84.9%	84.87%	1.03	1.05	1.6x	10.3x	14.3x	23.9x
All U.S. Firms	1.72	2.02	6.6%	6.0%	80.4%	81.20%	0.98	0.95	2.4x	11.3x	15.4x	26.8x
GDP	N/A	N/A	3.9%	3.2%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
LGIH long-run estimate	1.06		3.00%		90.00%		1.15		1.4x	17.4x	21.0x	29.4x

Capitalization

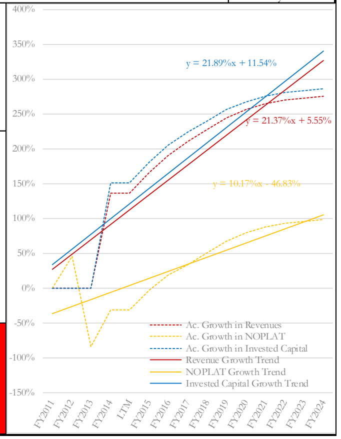
Operating Leases	100%
	Straightline
	10 years
R&D Exp.	100%
	Straightline
	10 years
Expl./Drilling Exp.	0%
	Straightline
	10 years
SG&A	0%
	Straightline
	10 years

Explicit Period Assumptions

	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023	FY2024	to ∞
Growth	135.4%	30.0%	25.0%	20.0%	18.0%	16.0%	12.0%	8.0%	5.0%	3.0%	3.0%	3.0%
Op.Costs/Rev.	87.6%	87.6%	88.0%	88.5%	88.5%	88.5%	88.5%	88.5%	88.5%	88.5%	88.5%	90.0%
WACC	8.44%	8.65%	8.72%	8.83%	8.95%	9.10%	9.25%	9.38%	9.52%	9.63%	9.73%	9.8%

Valuation

	LTM	LTM+1Y	LTM+2Y	LTM+3Y	LTM+4Y	LTM+5Y	LTM+6Y	LTM+7Y	LTM+8Y	LTM+9Y
NOPLAT	$30.2	$39.0	$47.0	$54.0	$63.8	$74.0	$82.9	$89.5	$94.0	$96.8
Invested capital	$372.8	$483.3	$595.8	$708.2	$829.2	$955.9	$1,069.3	$1,152.0	$1,207.7	$1,242.9
ROIC	8.1%	10.5%	9.7%	9.1%	9.0%	8.9%	8.7%	8.4%	8.2%	8.0%
UFCF	$30.15	-$71.46	-$65.58	-$58.38	-$57.23	-$52.69	-$30.57	$6.92	$38.25	$61.71
EVA	-$1.31	$8.72	$5.97	$1.66	$0.42	-$1.66	-$6.18	-$11.56	-$16.36	-$20.00
Terminal value										$1,404.32
Enterprise value (mid-year adj.)	$488.54	$613.96	$731.41	$852.07	$987.24	$1,130.89	$1,264.28	$1,372.32	$1,460.55	$1,534.99
Total Debt	$216.10	$216.10	$235.96	$277.26	$306.22	$333.45	$333.45	$333.45	$333.45	$333.45
Minority Interest	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Preferred Equity	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Capitalized Operating leases	$5.60	$13.36	$14.69	$15.88	$16.75	$17.46	$21.29	$22.06	$22.59	$22.92
PV of Unfunded Pension Plan Liabilities	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Dilutive impact of options,warrants, and converts	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Other claims on operating assets	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Non-operating cash and LT investments	$31.37	$29.64	$0.00	$0.00	$0.00	$0.00	$2.64	$44.73	$119.45	$220.50
Equity value	$298.21	$414.14	$480.76	$558.93	$664.26	$779.98	$912.18	$1,061.54	$1,223.96	$1,399.11
Shares outstanding	$19.85	$19.85	$19.85	$19.85	$19.85	$19.85	$19.85	$19.85	$19.85	$19.85
Price per share as of 3/26/2015	$16.38	$21.70	$25.13	$29.38	$34.81	$40.94	$47.67	$55.34	$63.67	$70.49



Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0%	10.0%	N/A	N/A	Normal
Op. Costs Variation	0%	10.0%	N/A	N/A	Normal
Market Risk Premium	5.5%	N/A	5.0%	7.0%	Triangular
Long term Growth	3.00%	N/A	-9.1%	140.3%	Triangular
Terminal Value	0%	10.0%	N/A	N/A	Normal

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$16.38	$21.70
$\sigma(\varepsilon)$	$0.11	$0.19
3 $\sigma(\varepsilon)$ adjusted price	$16.05	$21.13
Current Price	$15.20	
Analysts' median est.		$20.75

CGFS