BEHIND THE NUMBERS
Quality of Earnings Analysis
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D.R. Horton Inc. (DHI) Earnings Quality Update-12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are raising our earnings quality rating on DHI to a 5- (Strong).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

We are reviewing the 10-K from DHI's fiscal 4Q that ends in September. It is difficult to find anything materially wrong with the company's recent results. Business and orders remain strong and arguably there is a bit of a perfect storm going on as COVID actually fueled stronger demand for homes while at the same time labor costs were not seeing upward pressure. We are upgrading our rating on DHI to a 5- reflecting little risk of inventory write-downs in the near future and improved liquidity. The minus sign indicates some common influences on EPS all working in DHI's favor of late that may be difficult to repeat at current levels.

What is strong?

- Liquidity remains very high for DHI with $3 billion in cash vs. $4.3 billion in debt. Cash flow remains strong even with higher working capital investments consuming cash. Should business growth slow, cash flow will likely increase as working capital is released.

- Often where builders start to run into problems is when they run out of cheap land. DHI does not appear to be in that situation. It has 376,900 lots owned or on option and 2020

as a huge year resulted in 78,458 homes closed. DHI has nearly 5 years of land inventory.

- Gross margin benefited more from declining building costs in 2020. Pricing was essentially flat. There may still be more time with minimal cost pressure from wages and materials.

- DHI has continued to ramp up its warranty reserves even though the pace of claims has not kept pace with the increase in home volumes. This may be a tailwind for EPS in the future in the range of 4-8 cents.

What is weak?

- DHI is firing on all cylinders at the moment. The concern we have is several areas may not be sustainable at this pace and turn from being earnings tailwinds to headwinds.

- Gross margin normally is impacted +/- 40bp by changes in pricing vs building costs. In 2020, DHI gained 150bp largely due to building costs declining y/y. That seems to be a COVID related benefit where higher unemployment pushed down wages and subcontractors wanting to lock in business at the worst of the panic. This generated 63-cents of the $6.41 in EPS. This benefit may wane in 2021.

- Inventory impairments still occur – but nothing close to the 2007-11 timeframe. DHI still has projects it walks away from and forfeits deposits. In other cases, there can be cost overruns or disputes. These have been running about 11-cents in EPS. In 2020, a strong year for earnings, these impairments were only 5-cents.

- DHI's tax rate in 2020 received a $93.4 million benefit from retroactively reinstating a federal tax item for 2018 and 2019. It also includes an $11.2 million valuation allowance release. The lower effective tax rate added 29-cents to 2020 EPS of $6.41.

- Share repurchases added another 12-cents to 2020 EPS via lower share count. DHI can afford to continue buying shares and also recently boosted its dividend. DHI remains a cyclical company and we're not sure it will get much long-term credit for repurchasing shares on the way up and adding 2%-3% to EPS growth that is already double-digit. Simply maintaining an exceptionally strong balance sheet or paying special dividends may be better uses for that cash.

What to watch

- Inflation is a risk that still looking benign at the moment. DHI admits they do not maintain large supplies of building materials on hand so those costs may change quickly. Also, the company largely hires subcontractors to do the construction. That may lead to faster wage inflation.

- Cancellation rates are not getting worse at this time. If those increase, it could leave DHI with more spec homes to sell and extend the time to complete subdivisions. That could lead to impairments.

Supporting Detail

Gross Margin Strength May Have Some Pressure Going Forward

DHI's business has been very strong with sales growth of late. It has seen volumes grow with COVID and for the most part, DHI picks up homebuilding revenues via volume growth not price increases. Modest price increases do happen in some markets, but others see declines.

Home Sales	f2020	f2019	f2018	f2017
Home Revenues	$19,560.8	$16,925.0	$15,502.0	$13,653.2
Growth y/y	15.6%	9.2%	13.3%	15.9%
Volume y/y	14.8%	9.9%	13.3%	13.5%
Price y/y	0.7%	-0.6%	0.2%	2.1%

Gross profit had a sizeable gain in several areas in fiscal 2020 too. Here are the following areas broken out:

Home Gross Profit	f2020	f2019	f2018	f2017
Gross Margin	21.8%	20.2%	21.3%	20.0%
Home Price Chg.	0.0%	-1.3%	0.6%	0.0%
Home Cost Chg.	-1.5%	0.0%	0.0%	0.0%
Purchase Acct Chg.	0.2%	-0.1%	0.0%	0.0%
Warranty & Defects	-0.2%	0.2%	0.4%	-0.5%
Capitalized Interest	0.1%	0.1%	0.3%	0.3%
Net Change y/y	1.6%	-1.1%	1.3%	-0.2%

- DHI reports home price change and cost of home change as a net figure. They call out the stronger part of it. So in fiscal 2020, falling home costs were the key to a 150bp boost in margin, while in fiscal 2019, falling home prices led to a 130bp drop in margin.

- Purchase Accounting changes relate to prior acquisitions and adjustments to fair market values placed on assets. This primarily deals with land acquired via the Forestar deal. Acquisitions remain a modest part of DHI's business model.

- Warranty and defects are spending to repair homes that have been delivered to customers.

- DHI capitalizes interest costs during construction of homes and that is added to homebuilding costs.

Looking at 2020: EPS was $6.41. Gross margin was 160bp higher than the year before. Driving this was primarily having a year when housing costs declined 150bp. This was likely helped by COVID to some degree creating more unemployment and make it easier to hire labor and materials may have seen some cost deflation too. DHI uses many subcontractors and they could have reduced their bids in late spring/early summer during the fear stages of COVID to lock-in some contracts. The company gained 63-cents from this margin source. DHI saw 8-cents of headwind from higher warranty and defect costs, but that was offset by the purchase accounting adjustments for 8-cents also. Lower interest costs added 4-cents as interest rates declined as well.

Looking at 2019: It also helped set up DHI's 2020 with an easy margin comp since pricing on homes declined 130bp. Of the $4.29 in EPS, this loss of pricing cost the company 44-cents in EPS. Lower warranty and defect costs helped by 7-cents in 2019 and the other items were a wash.

We think this is more a case of sustainability of results than a problem in earnings quality. When we looked back in time, we had to go to 2013 as the last time DHI was able to see net home price/cost rise as much as 2020 and in 2013 it was fueled but cutting sales incentives and pent-up demand after years of subpar volumes. DHI still has a strong backlog so we don't see signs that home volumes will drop by a large degree. We would just question if DHI will experience another year where it gains 150bp due largely to housing construction costs falling. In most years, the net +/- of pricing/cost changes is about 40bp. And don't forget, 2020 had a very easy comp of -130bp from 2019.

It is also possible that Warranty expense becomes a slight tailwind going forward. Despite having it be a small tailwind in 2018 and 2019, DHI continued to build the reserve as volumes

grew. This also happened in 2020 when even settlements fell. We also noticed that warranty cost to boost the liability in pre-existing warranties is dropping. This normally has to do with DHI fixing some items that are off warranty but it sees it as building goodwill with customers:

Warranties	f2020	f2019	f2018	f2017
Starting Reserve	$247.3	$202.0	$143.7	$104.4
New Warranties	$114.4	$92.7	$81.6	$69.7
Chg. To Prior War.	$25.5	$32.0	$49.3	$30.0
Settlements	-$77.0	-$79.4	-$72.6	-$60.4
Ending Reserve	$310.2	$247.3	$202.0	$143.7

Inventory Impairments – Tailwind for Earnings May Not Last

Most investors fear the type of impairments that happen when housing demand is in decline. We currently do not see this risk as an imminent danger given the strength of the backlog and recent growth. This is still a cyclical business so the risk does remain. One of the biggest misunderstandings when it comes to impairments for a housing company is that the size of the write-off is limited to what is on the balance sheet as housing inventory or land/lot inventory. As we have discussed in the past, that is not true.

The exercise in determining impairments requires the company to estimate what its total future expenses will be to complete a housing project and the estimated cash flows and timing for when that will be received. The builder may have one-third of the project costs listed as inventory. However, the impairment will look at both the existing one-third already incurred PLUS the additional two-thirds that needs to be spent. If costs are coming in above forecast it can cause an impairment for the whole project as the expected net cash flow in vs. out will be lower.

What normally happens during a housing downturn is the expected cash inflow takes a hit. They have to discount prices, offer other incentives to move property, buyers walk away from homes under contract and the builder ends up owning more spec homes, and the time to sell all the properties may take longer. All that impacts the cash inflow estimates. The net result is a company may have say $100 million listed in inventory that is carried on an estimate it will earn a 20% margin. However, to complete the full project, the total spending required may be $400 million. With sales prices falling, extra costs, and added time to close out the project, the estimate may be that the revenue coming in may only be $370 million. Thus, the impairment is looked at as a $400 million cost, not $100 million, and those costs will not be recovered and take longer to close out. The impairment may be $150 million even though inventory is only listed at the moment at $100 million.

The company can often walk away from options on lots that have not begun construction. However, when dealing with full subdivision projects – they need to account that they may lose money on each unit and have several still to complete. Impairments of this magnitude have not been seen since 2007-09 with a decent impairment in 2011 as well.

What some do not realize is that impairments still happen in most years – but they tend to be much smaller. These can be projects there were contemplated but DHI walked away from and forfeited earnest money or deposits. There can also be isolated incidents of particular markets that may create a write-down. Some would basically call these types of impairments immaterial:

Impairments	f2020	f2019	f2018	f2017
Homebuilding	$1.7	$24.9	$10.9	$23.2
Earnest money forfeit	$21.2	$28.3	$13.4	$17.0
Disputed on land deal	$0.0	$0.0	$24.5	$0.0
Settlements	$22.9	$53.3	$58.8	$40.2
EPS Impairment	$0.05	$0.11	$0.11	$0.07
Total EPS	$6.41	$4.29	$3.81	$2.74

So, while impairments of the truly material amounts likely require some pricing erosion of new home values to occur and we don't see the signs of that now – can the impairment area show much more improvement for DHI this year? To us, it looks like a sustainability issue that will be difficult to maintain.

Share Repurchases Help EPS Growth – DHI has Cash Flow to Support It

DHI has helped EPS growth by buying back shares. Last year it added 12-cents to growth:

EPS Growth	f2020	f2019	f2018	f2017
# shares	370.2	377.4	383.4	378.9
Reported EPS	$6.41	$4.29	$3.81	$2.74
Growth	49.4%	12.6%	39.1%	16.1%
EPS from repos	$0.12	$0.07	-$0.04	-$0.03
Growth from repos	2.8%	1.8%	-1.5%	-1.3%

The growth rate in EPS has wide fluctuations since DHI is a cyclical company. We're not sure the money spent repurchasing shares has a meaningful impact here. It did just increase the dividend to 20-cents per quarter, which amounts to a 1.1% yield. In our view, a stronger case may be to focus more on higher dividends than repurchasing shares at current prices.

In DHI's defense, it has $3 billion in cash and only $4.3 billion in debt. It is not a serial acquisition machine either. Goodwill is $163 million against $12.1 billion in equity or just a tad over 1%. Because DHI uses subcontractors extensively for homebuilding, its capital spending needs are minor too. So looking strictly at free cash flow, paying for the dividend and repurchases is doable:

Cash Flow	f2020	f2019	f2018	f2017
CFO	$1,421.6	$892.1	$545.2	$440.2
CapX	$96.5	$127.2	$68.1	$102.7
Acquisitions	$9.7	$315.8	$159.2	$4.1
Free Cash Flow	$1,315.4	$449.1	$317.9	$333.4
Dividends	$256.0	$223.4	$188.4	$149.6
Repurchases	$360.4	$479.8	$127.5	$60.6

The two other things worth pointing out on cash flow is the inventory consists of land and houses so it is a hefty investment. As the company has grown, cash from operations is penalized by the rising working capital outlay. If business grows at a slower rate or declines, some of that working capital should be freed up. Also, DHI has some multi-family rental properties it has built and sold as well and that is also adding to cash flow:

Cash Flow	f2020	f2019	f2018	f2017
CFO	$1,421.6	$892.1	$545.2	$440.2
Working Capital	-$1,105.0	-$902.8	-$1,246.9	-$853.8
Adj. CFO pre W/C	$2,526.6	$1,794.9	$1,792.1	$1,294.0
Asset sales	-$60.5	$46.9	$222.7	-$54.6

Working capital increases are consuming about half the cash flow before that investment. So, the fact that DHI is still supporting its dividend (which will be about $295 million per year after the recent increase vs. $256 million in 2020), repurchases, and remains highly liquid is a big plus. It still seems unlikely that it will get much credit for buy back shares as the business is expanding, nor is it materially changing the EPS growth rate. We'd rather see DHI either pay special dividends or just bank the money with a fortress balance sheet to take advantage of cheap stock and assets the next time there is a down cycle for housing.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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