BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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D.R. Horton (DHI) EQ Update
12/19 Quarter

Current EQ Rating*	Previous EQ Rating
4+	4+

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

We are maintaining our earnings quality rating of 4+ (Acceptable)

The cyclical nature of the company and industry makes continual improvement in results difficult. We feared last year that DHI could have some negative news on pricing trends, volume trends, and that impairments could not remain at extremely low levels. All of those trends modestly retreated in fiscal 2019. In terms of earnings quality and low risk of write-down, we consider DRI among the top in the group. The ultimate risk remains a write-down in inventories – but there are not many signs of that at this time.

The basics of the inventory write-down stem from homebuilders have a large inventory balance with much of it still under construction. Where big problems arise is not from forfeiting deposits on future lots, but the company has to estimate the cost to complete current projects, estimate the future sales prices, and estimate the time until the sale and discount that back to NPV. Thus, the size of the write-down can become larger than the current inventory figure.

For that risk to be a realistic near-term problem we think there need to be signs that the cancelation rate is rising – but it is actually ticking down at DHI. There would need to be signs that unit volumes are falling – but they are not, DHI just raised guidance for units. Widespread signs that prices for houses are falling are not happening other than in the West

where DHI has fairly low exposure. Also, minor impairments on spec homes and other needed modifications should be rising noticeably – but remain near record lows at DHI.

We want to highlight that DHI posted higher EPS in fiscal 2019 and raised guidance after 1Q20.

	f2019	f2018	f2017
EPS	$4.29	$3.81	$2.74
Dividend	$0.60	$0.50	$0.40
Shares O/S	377.4	383.4	378.9
Sales $ in bills	$17.6	$16.1	$14.1
Homebuild GM	20.2%	21.3%	20.0%

- **Impairments rose off very low levels and became a 6-cent headwind in 2019 vs. 2018. If it rises to $100 million in 2020, it would be a 10-cent headwind.**

- **Purchase accounting adjustments on inventory was a 4-cent EPS headwind in 2019.** Marking up values of inventory is actually a positive sign that impairments are unlikely to rise much in the near term.

- **The acquisitions have helped DHI add land at lower prices. The company's cost structure should also be helped that lots under option have remained flat for years** as costs of building homes has increased lately. Flat lot prices should mitigate margin pressure.

- **Gross margin came under pressure from building costs rising faster than selling prices. Even with lower margins in 2019, the rising unit volume more than offset that pressure.** Current guidance on units would need to see another 100bp of gross margin pressure by our estimates to make EPS growth 0-18 cents. Our concern last year was that gross margin was unsustainable, but it has returned to levels posted in 2016 and 2017.

- **Given less exposure to California and thus less exposure to negative home pricing, we see little risk of near-term sizeable inventory impairments at DHI.** Recently boosted unit sales guidance also gives more cushion against inventory impairments as that volume can offset the margin pressure.

Impairments Were up in 2019 as We Thought Might Be the Case – EPS Hurt by 6-Cents in 2019

Impairments	f2019	f2018	f2017
Land	$28.3	$13.4	$17.0
Home Inv.	$24.9	$10.9	$23.2

In 2019, impairments cost the company 11-cents in EPS vs 5-cents in 2018. Compared to periods such as 2007 and 2008 when impairments were $1.2 billion and $2.4 billion – these figures remain very modest and rising from 15bp of margin to 30bp in 2019 and are simply a cost of doing business. There is $5.9 billion in land and lot inventories and $5.2 billion in home inventories. **We do not see enough evidence to call this out as a problem. To us, it was simply a situation of it being very tough to maintain very low 2018 levels.**

In our view, the recent increases in home and land prices limited write-downs. In 2018 and 2019, the price increases stalled:

Pricing y/y	f2019	f2018	f2017	f2016
Full DHI	0%	0%	2%	2%
Southeast	1%	1%	1%	1%
South Central	0%	0%	4%	4%
West	-3%	-2%	5%	6%

Now when a house is taken back via cancellation or a modification has to be made, the company is not experiencing price appreciation at past levels. A part of the impairment calculation includes forecasting what additional costs still must occur before the property is sold, and higher prices may not be helping to offset the higher costs. Also, it is discounting its inventory's cash flows to compute impairments at 16%-18%. Thus, delays in getting to a sale can also push down the carrying value of the inventory.

This has also seen some of the gross margin coming off the highs of 2018. Of the five regional markets served DHI – the East (13% of sales) noted that gross margin fell 130bp due to the average cost of homes rising faster than the average selling price. The South Central (25%) of sales reported a 50bp drop in gross margin due to home costs rising faster than home prices. The West (21% of sales) saw a 270bp decline in gross margin as selling prices

declined against a small increase in home costs. Only the Southwest (5% of sales) reported at 130bp increase as home prices growth exceeded increases in costs.

In the near term, sales remain brisk and the company boosted sales guidance. As we'll discuss later, they also still own their land fairly inexpensively. DHI also focuses on lower-priced and entry-level homes too. That also limits impairments. **Even if impairments rise to $100 million – it becomes a 10-cent headwind on EPS.**

Purchase Accounting for Acquisitions Hurt Gross Margin and EPS by 4-cents in 2019

Another reason sizeable inventory impairments seem unlikely in the near future is after making some modest acquisitions – the accounting after the close boosted the value of the acquired inventory. In 2019, there were three small deals, the inventory purchase adjustment boosted Cost of Goods by $18.5 million. That was a 4-cent issue for EPS.

The company noted that this was 10bp of total gross margin decline for the year. We didn't mention the Midwest unit above on gross margin because it bore the brunt this inventory write-up. The Midwest is only 7% of total sales but saw a 360bp gross margin decline last year largely due to the purchase accounting.

In 2018, there was a similar deal with the Forestar acquisition that boosted Cost of Goods by $17 million and cost the company about 4-cents in EPS in 2018 also.

The purpose of acquisitions was to acquire more control over land for future homes. So, it is definitely in the DHI wheel-house. Also, the acquisition costs were fairly modest and the company can easily afford it. There is $1.6 billion in cash after making acquisitions of $316 million and $159 million. Debt to equity is only 0.36x. Net of the cash, that ratio is only 0.21x. From a cash flow standpoint, working capital consumes cash when the company is growing in the form of mortgages and inventory of lots and houses under construction. Free cash flow before working capital growth was $1.66 billion in 2019.

We also believe the acquisitions have given the company the ability to acquire lots for a low price. The total purchase price in 2019 was $326 million and came with 700 homes in inventory, 4,500 lots, and another 4,300 lots with purchase contracts. The average home DHI sells in the Midwest is about $340,000-$350,000. Let's say the acquired homes are

worth $300,000 * 700 units or $210 million. **Allocating the remaining 4,500 lots over $116 million is under $26,000 per unit and giving zero value to the purchase options on 4,300 other lots.**

In 2018, before the acquisitions, DHI had $208 million invested in 3,800 Midwest lots or an average unit price of $54,740. That's overstating the figure as there were 9,300 lots under contract that had some impact on the total $208 million figure. But, we think DHI was able to buy assets lower than what it had been paying and get a large amount of land in three transactions.

Total Gross Margin Came Under Pressure in 2019 – Higher Volume Offset It – It May Continue

Homebuilding margins were down 110bp last year. The company was hurt by the purchase adjustments noted above for 10bp and helped by 10bp due to lower capitalized interest amortization and 20bp from lower warranty/defect costs. The other 90bp of net lower margin came from average building costs rising faster than average home prices.

Given recent pricing trends, we do not see relief coming for margins. At the same time, we have always liked DHI for a small exposure to California. The West region is only 21% of sales and includes Washington, Oregon, Nevada, Utah, and Hawaii also. That is the one area that is seeing falling prices and would negatively impact gross margin.

Also, looking at the lots under option with the deposits and remaining purchase options, we think DHI has done a good job holding its future land costs fairly flat:

Lot Options	f2019	f2018	f2017	f2016
Units	185,900	164,200	124,000	91,600
Deposits	$515.4	$401.8	$227.6	$167.0
Remaining Payments	$7,200.0	$6,500.0	$4,600.0	$3,600.0
Price/Lot	$41.5	$42.0	$38.9	$41.1

The lot options have been fairly steady at about $41,000 per unit. Also, the average selling price of a house at DHI is $298,000, which makes the lot cost under 14% of the total price. We think that gives DHI some cost relief.

The bigger picture is volume is still growing rapidly:

	f2019	f2018	f2017
Units Closed	56,975	51,857	45,751
Unit Growth	9.9%	13.3%	13.5%

January forecasts are for f2020 to come in at 60,000-61,500 units, which is 5.3%-7.9% growth.

The gross margin decay in 2019 was more than offset by the higher volume:

	f2019	f2018	f2017
Home build Rev	$16,925	$15,502	$13,653
Home build GM	20.2%	21.3%	20.0%
Gross Profit	$3,419	$3,302	$2,731
Change from Vol.	$304	$369	
Change from GM	-$187	$202	

In 2019, the margin decay in homebuilding cost 39-cents in EPS, but volume added 64-cents. When we apply the unit guidance for 2020 – on flat gross margins – EPS would grow 38-57 cents. A 50bp decline of gross margin on unit guidance would still lead to 19-37 cents of EPS growth. A 100bp decline would still have EPS growth between 0-18 cents.

Explanation of EQ Rating Scale

Rating	Explanation
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 Concerns"	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 may 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 the next quarter. 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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