BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

January 31, 2019

www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

# Homebuilder Primer

Over the next couple of weeks, we plan to look at the larger homebuilders for earnings quality issues and a few more industry-specific measures. Longer-term clients will remember that we followed this group heavily in the years 2005-09. There were several issues we had with the companies and the overall fundamental back-drop that we reviewed. These included:

1) For 50-years, homeownership in the US had been 64%-65% and suddenly it surged to 69% in just a few years. The homebuilders benefitted from these millions of extra home sales.
2) Many of the companies had purchased cheap land years before and marking up land values was the bulk of their profits.
3) Investors were conditioned to believe that because much of the land was controlled with options to buy, the homebuilders only risked minimal potential of sizeable asset write-downs.
4) Inventories of homes under construction and existing spec homes were actually a much larger area for asset impairments in a downtown.
5) Several unconsolidated joint ventures and other entities carried high debt levels and often led to either cash outflows to support them or additional asset impairments.

**At this point, we do not see overwhelming evidence of a housing bubble. However, the turnaround phase of value investing and rapid earnings gains in the homebuilders from returning to normal times may be over.** It may make sense to differentiate the primary players on some risk factors and whether they have more conservative or aggressive accounting policies and operating methods. In addition to reviewing joint ventures, earnings levers, and accounting noted above, we will introduce a couple new risk areas that we will view in the context of the macro housing numbers:

- Housing ownership rates have returned to long-term levels and housing starts have more than doubled off several all-time low years.

- Arguably, homebuilding is reaching equilibrium based on annual razed homes, population growth, and population movement at the current 1.3 million starts.

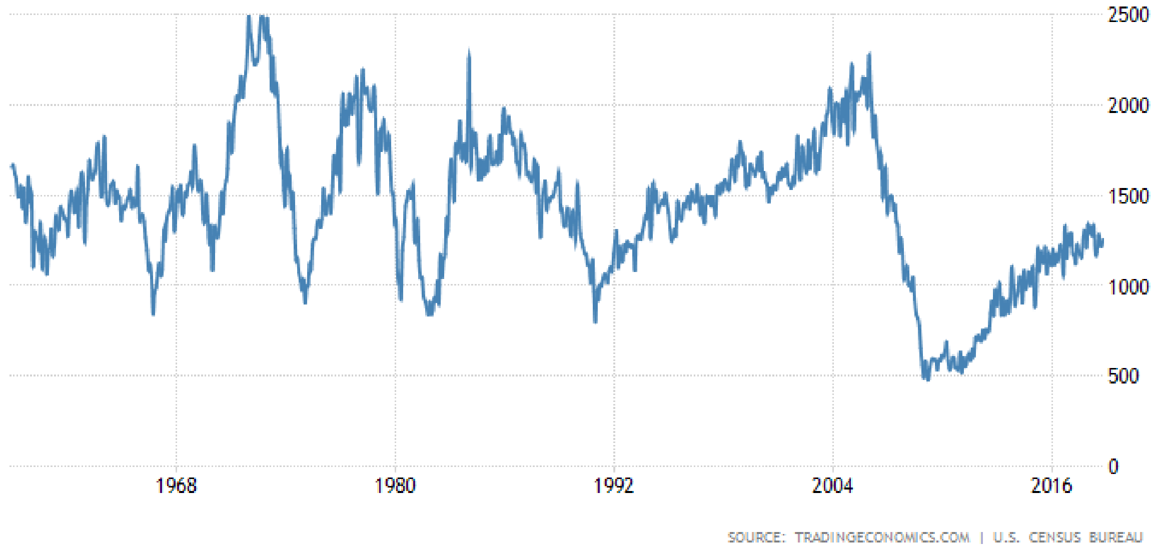
- Home sales have been rising amid higher interest rates – we think the risk that a sale occurs or doesn't over 50-100bp is overblown. However, homebuilders dependent on raising prices to drive EPS growth may find boosting prices amid rising rates more difficult.

- Population movement within the country is very pronounced in our view from high-tax areas to low-tax areas. Areas with new population due to relocation may be stronger for builders and those losing population could be a problem for builders. So, we want to review geographic concentration for the players in the industry.

## We believe the housing bubble excesses have been absorbed

Our evidence for that is that the market has absorbed the foreclosures from 8-10 years ago and homeownership rates have returned to normal. Here is the data from the St. Louis Fed from 1965 on. Ownership rose after WW2 above 60% and stayed there for decades. This data shows 63%-65% for another 35 years until the 2000's arrived and homeownership rates jumped to 69% in 2006 before bottoming at 63% again in 2016. **The market is back to 65% homeownership rates.**

It is important to remember that the home ownership rate is not a population driven percentage. During all those years, population growth was still seeing more people buy homes even though the percentage of people owning homes did not change. **The basic figures we have seen are 300,000 homes are destroyed every year – fire, flood, cleared for a new football stadium, or simply torn down. Population growth requires about 400,000-500,000 new homes per year. That puts equilibrium at about 750,000 new homes needed per year.** On top of that, there are homeowners with multiple homes – some are rentals, some are homes in transition where a family buys a new one but has not or cannot sell the prior home, and vacation homes. That puts total new homes needed at about 1.3-1.5 million units per year as a longer-term situation. That figure moves around at the margin based on the economy. The market is also back to the 1.3 million figure for new homes being built:




If you want to see the housing bubble, this chart shows it well. An extra 1% of homeownership is about 1 million new homes. Adding 0.3%-0.6% per year for several years is how housing starts stayed above 1.5 million for well over a decade. And the housing bust is obvious too, with several years of housing starts around 0.5 million, which was not even replacing homes being torn down and population growth. Even in years of 18% interest rates in the early 1980s and a smaller population, the US was routinely building 1.0 million new homes, so the level of the bust was severe in our view.

Thus, from a total market standpoint, we do not see significant red flags. Bulls can argue the market has room to move closer to 1.5-1.8 million housing starts and bears can argue that the new normal is actually 1.0 million. Under either situation, the homebuilders may not see the same level of difficulty as falling from 2.2 million starts to 0.5 million or maintain the same level of euphoria as going from 0.5 million to 1.3 million. Those big moves appear unlikely.

## However, two additional macro risks exist in our view – Interest Rates and Population Migration.

Given that the media focuses on nothing but interest rates and the FED 24/7 these days, we do not think many people are unaware of that risk. However, we do not think it is viewed correctly. There are clearly more than financial reasons why people buy homes. We would never have done 1 million housing starts with rates at 18% in 1980 when the buyers had a history with 4%-5% rates if financing costs were the primary issue. The current interest rates remain historically low and have been increasing due to the economy gaining strength and more jobs being created, which probably play a bigger part in why more homes are being bought even as rates have increased. There should be a difference between 3% mortgage rates and 9%, but no one is fearing that in the next couple of years. We do not see the risk that homebuilders who have seen sales volumes nearly triple from the lows with interest rates rising from the 3% to 4% level will see no one buy at 4.3% rates. History has disproven that too many times – rates were rising in 2006 during the industry's banner year and have risen over 100bp since 2016 yet sales are increasing.

**We see the risk of modestly higher rates is not that people will buy fewer homes but instead will buy modestly cheaper homes.** Mortgages and homes are sold based on the monthly payment. Borrowing $300,000 for 30 years at 4% is a $1,432 payment. At 4.5%, the payment becomes $1,520 (6% higher) and at 5.0% the payment rises 12% to $1,610. That $80-$90 per month can be reduced or eliminated by cutting $5,000-$15,000 off the home price. **That's the risk to the homebuilders in our view – many have been increasing EPS via raising prices.** If people can still buy the house but cut a few corners, and the builder sees flat pricing, earnings growth could be impaired. We will discuss this factor for the various builders we review.

**We also do not think it is a big surprise for many to hear that people are moving from high-tax areas to low-tax areas.** The number of electoral votes is allocated on population and states like New York, Michigan, and Illinois are steadily losing electoral votes. From 1980 to 2020, New York lost 12 votes, Michigan 5, Illinois 6. California gained 10 but has only gained 1 since the 1990 census. Meanwhile, Texas and Florida have each gained 12. U-Haul reservations can show this trend too via supply/demand for moving truck rentals. We choose some cities at random, renting a 26' truck on March 1, 2019:

Pickup in Brooklyn, NY and dropping off in Jacksonville, FL is $3,303
Reverse that trip starting in Jacksonville – the rate is $726

Pickup in Chicago, IL and dropping off in Tampa, FL is $1,896
Reverse that trip and start the trip in Tamp – the rate is $846

Pickup in Los Angeles, CA and dropping off in Dallas, TX is $3,790
Reverse that trip starting in Dallas – the rate is $1,138

**We believe that homebuilders with larger operations in states with growing populations should have less risk than those with larger operations in states with flat or shrinking populations**. Nationwide, the country could do 1.4 million new home starts and not make much news. But, within that total, Texas could be up 10% and California down 8%.

# Disclosure

*BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.*

*The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.*

*This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.*

*Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.*