Dropping Coverage of the Homebuilders Industry

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Previous | Next

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Valuentum is dropping coverage of the homebuilders industry to allocate resources elsewhere.

Structure of the Homebuilders Industry

The meltdown in housing late last decade is a prime example of the extreme cyclicality of the homebuilding industry. Housing market health is determined by a number of variables: consumer confidence, employment, household formation, replacement demand (natural disasters), inventory (existing/shadow), interest rates, lending standards, and housing prices themselves. The market is far from homogenous, and stronger builders focus on regions with favorable supply/demand characteristics and pursue lot options instead of land purchases. Still, we don't like the structure of the group given its boom and bust nature.

CalAtlantic (CAA)

CalAtlantic has agreed to be acquired by Lennar in a cash and stock deal valued at ~$9.3 billion that will create the nation's largest homebuilder. Our new fair value estimate approximates the deal price.

CalAtlantic is the result of the merger of two of the premier homebuilders in the US, Standard Pacific and Ryland. The firm builds single-family attached and detached homes in 17 different states. The combined company delivered nearly 13,000 homes annually on a pro forma basis prior to the transaction. It is headquartered in Irvine, California.

CalAtlantic anticipates that production, purchasing, and other synergies from the transaction have the potential to reach $50-$70 million in annual cost savings. Though a material portion of these savings were realized in 2016, additional cost benefits are expected in 2017.

CalAtlantic has agreed to be acquired by Lennar in a cash and stock deal valued at ~$9.3 billion that will create the nation's largest homebuilder. Each share of CalAtlantic stock can be exchanged for 0.885 shares of Lennar, or shares can be exchanged for $48.26 per share with the cash consideration capped at ~$1.2 billion. The deal is expected to close in the first quarter of 2018.

Lennar's purchase of CalAtlantic is expected to result in annual cost savings and synergies of ~$250 million, with ~$75 million expected to be realized in fiscal 2018. The company will control ~240,000 homesites and have ~1,300 active communities in 49 markets across 21 states, where roughly half of the US population currently lives.

CalAtlantic has a highly diversified market presence as it operates in 41 different metropolitan markets as of the first quarter of 2017. California, Florida, and Texas account for 25%, 17%, and 15%, respectively, of home sale revenue.

Our published fair value estimate range for CalAtlantic is $32-$66 per share, with a Valuentum Buying Index rating of 6 and an Economic Castle rating of Neutral

D.R. Horton (DHI)

Things are on the up and up at D.R. Horton, and it recently agreed to acquire 75% of land developer Forestar Group.

D.R. Horton is one of the largest homebuilding companies in the US. Its homes generally range in size from 1,000 to 4,000 square feet and in price from $100,000 to $600,000. The firm also provides mortgage financing services through DHI Mortgage. It was founded in 1978 and is headquartered in Fort Worth, Texas.

After a half-decade of uneven price retreats, declining interest rates, and a whole lot of litigation, the US housing market appears to finally be on solid footing. Consolidation may be heating up in the industry, and D.R. Horton has agreed to acquire 75% of land developer Forestar Group for ~$560 million.

Pent up housing demand has been accruing for years, and new home inventory is limited, which makes for an environment conducive to driving housing price improvements (as a result of simple supply/demand dynamics). Though we acknowledge the concept of “shadow inventory”--sellers currently without a ‘for sale’ sign in their front yard--overall inventory trends continue to move in the right direction.

The last industry downturn brought about change at D.R. Horton. The firm has been focusing on cash flow and reducing debt, and it has implemented restrictive land and lot inventory investment guidelines. Its home sales gross margin has expanded considerably since 2011, and its sales backlog stands at ~$4.4 billion as of March 2017.

Things are on the up and up at D.R. Horton. Through three quarters in fiscal 2017, for example, net sales orders in homes increased 13%, while net income advanced 20%. Solid performance in its three core brands is enabling the firm to expand its industry-leading market share.

Our published fair value estimate range for D.R. Horton is $24-$40 per share, with a Valuentum Buying Index rating of 6 and an Economic Castle rating of Unattractive.

D.R. Horton's dividend is far from healthy. We wouldn't be surprised to see it cut once again should the housing market experience another downturn.

D.R. Horton has been the #1 builder in the US for 15 consecutive years as of fiscal 2016. When the housing market was crushed during the Financial Crisis, the company was forced to reevaluate its dividend policy. Now that the market appears to have regained solid footing, D.R. Horton has begun allocating additional capital to its dividend. In 2014, the company raised its dividend for the first time since cutting the payout in 2008. For the time being, D.R. Horton should stay focused on improving its free cash flow generation and delevering its balance sheet. If it’s successful, then returning to dividend growth would make sense, in our view.

D.R. Horton operates in a highly cyclical, capital intensive industry whose health relies on a variety of variables. During the housing crisis, D.R. Horton lowered its dividend in order to maintain higher levels of cash for other uses of capital. Since then, the company has faced some significant headwinds. The firm's ability to capitalize on its initiative to efficiently manage land and home inventory levels may be worth watching as it relates to the consistency of cash flow generation moving forward. As it stands, D.R. Horton’s poor free cash flow generation and a sizeable debt load provide some obstacles if the company wants to return to material dividend growth. The combination of the two contribute to D.R. Horton’s unfavorable Dividend Cushion ratio.

Our published Dividend Cushion ratio for D.R. Horton is -0.9 with a Dividend Track Record of Risky.

St. Joe (JOE)

Proceeds from land sales in the future will largely drive what St. Joe is ultimately worth.

St. Joe is one of Florida's largest real estate development companies. The firm owns ~178,000 acres located between Tallahassee and Destin. It has significant residential and commercial land-use entitlements in hand or in process. The company was founded in 1936 and is headquartered in WaterSound, Florida. Traditional valuation metrics such as a PE ratio or PEG ratio and even the discounted cash-flow model don't add much value in evaluating St. Joe's intrinsic worth. Proceeds from land sales in the future will largely drive what St. Joe is ultimately worth.

Pent up housing demand has been accruing for years, and new home inventory is limited, which makes for an environment conducive to driving housing price improvements (as a result of simple supply/demand dynamics). Though we acknowledge the concept of 'shadow inventory,' overall inventory trends continue to move in the right direction.

In early 2014, St. Joe sold ~380,000 acres of land for $562 million, which included $200 million in the form of a timber note. Though the land sold was nonstrategic, at $1,400 per acre, it would value the remaining ~178,000 acres on its books at the end of 2016 at nearly $250 million. Management continues to buy back stock.

Though land prices will be volatile, we're generally optimistic about St. Joe's future. The retiree demographic presents the firm with a unique longterm opportunity given that it owns a substantial amount of land in a desirable part of the US.

Our published fair value estimate range for St. Joe is $10-$20 per share, with a Valuentum Buying Index rating of 6 and an Economic Castle rating of Neutral.

K.B. Home (KBH)

We've raised our fair value estimate for KB Home as a result of increased top-line expectations. Average selling price increases have been impressive of late.

KB Home is one of the largest and most recognized homebuilding companies in the US. Its homebuilding operations offer a variety of new homes designed primarily for first-time, move-up and active adult homebuyers. The firm was founded in 1957 and is headquartered in Los Angeles.

After a half-decade of uneven price retreats, declining interest rates, and a whole lot of litigation, the US housing market appears to finally be on solid footing. Though mortgage rates are now (slowly) on the rise, housing market confidence is as high as it has been in over a decade.

Higher revenues and enhanced margins with improved fixed cost leverage are helping produce stronger bottom line results at the homebuilder. We've raised our fair value estimate for KB Home as a result of increased top-line expectations. Average selling price increases have been strong of late, and backlog growth has been solid on a unit basis but even more impressive in terms of total value.

KB Home's strategy and the general market recovery are driving average selling price (ASP) growth. For example, the firm's ASP has expanded to $365k in the first quarter of 2017 from $271k at the same time in 2013. Higher-priced sub-markets and first-time buyers selecting larger homes are two contributing factors.

First-time buyers represent roughly 60% of KB Home's business, down from more than 70% during the housing crisis in 2009. Management remains committed to this demographic, which is the largest home-buying demographic in the market.

Our published fair value estimate range for K.B. Home is $15-$25 per share, with a Valuentum Buying Index rating of 6 and an Economic Castle rating of Unattractive.

KB Home's dividend is not attractive at all. The firm has cut its payout multiple times since the Financial Crisis.

The recent strength of the cyclical housing market has been a key driver of positive momentum for KB Home. We think the firm will take this upswing to continue to capitalize on the positive industry outlook and strengthen its financial position. It has only returned to profitability in 2013, and the company has a number of key strategic initiatives, including those focusing on improving asset efficiency to drive free cash flow generation and higher return on invested capital. Its deferred tax assets should provide a nice bottom-line tailwind in coming years. We think dividend growth should be a low priority at the company, especially in light of its debt load.

KB Home took the housing crisis of the late 2000s as hard as any home builder. Significant earnings volatility can be expected due to the cyclicality of the housing market; such conditions have forced the firm to cut its quarterly payout a number of times since late 2008. Though we applaud management's capital management and free cash flow initiatives, we don't think they will have material impact on the firm's dividend potential in the near term. The firm's Dividend Cushion ratio is one of the worst in our coverage universe, and we don't expect KB Home to return to dividend growth anytime soon. That said, the board can do whatever it wants until it can't.

Our published Dividend Cushion ratio for KB Home is -27.1 (NMF) with a Dividend Track Record of Risky.

Lennar (LEN)

If Lennar can navigate its debt maturities effectively, its operating performance should remain strong thanks in part to higher home prices and lower incentives.

Lennar is one of the US' largest homebuilders and a provider of financial services through its Rialto segment. The company is also an investor and manager of funds that invest in real estate assets. Its massive losses suffered during 2007 through 2009 have led to large net operating loss carryforwards, which can result in significant future tax benefits.

The underproduction of homes in the years immediately following the Great Recession has created pent-up demand, and the company continues to gain share from weakened private homebuilders. Lennar's relatively attractive land purchases have positioned it for strong margins in a healthy market.

Lennar has agreed to acquire CalAtlantic in a cash and stock deal valued at ~$9.3 billion, inclusive of debt, that will create the largest homebuilder in the US. Roughly $250 million in annual cost savings and synergies are expected, with ~$75 million expected to be realized in fiscal 2018. Management expects the deal to close in the first quarter of 2018 and to be materially accretive to fiscal 2019 earnings.

One key benefit behind the CalAtlantic deal is increased scale in areas in which Lennar already has a presence. The to-be-combined entity will have control ~240,000 homesites and will have roughly 1,300 active communities in 49 markets across 21 states where approximately 50% of the nation's population currently resides.

The biggest risks to Lennar, besides its debt load, relate more to external forces than anything operational. Changes in government, economic policies and/or a significant, rapid and sustained rise in interest rates could slow orders for new homes.

Our published fair value estimate range for Lennar is $36-$60 per share, with a Valuentum Buying Index rating of 6 and an Economic Castle rating of Attractive.

Lennar doesn't appear to be focused too much on restoring its dividend after cutting the payout in 2008.

Lennar's strategy has been to use the cyclical nature of its industry as its ally, which is much easier done during the upswing in the cycle than during a trough. We expect the firm to use the current strength in the housing market to focus on strengthening its fundamentals as it takes advantage of a few tailwinds in the industry. As part of its list of initiatives, management is looking to use its land strategy to improve free cash flow generation, as well as continuing to target a strong, liquid balance sheet and improving credit metrics. We like the current outlook of the housing market, but Lennar's focus should not be on growing its dividend, which it is not.

Lennar's dividend is wrought with weaknesses, as its dismal Dividend Cushion ratio suggests. The cyclical nature of the housing industry has taken a significant toll on the firm's dividend prospects, and it was forced to cut its quarterly payout by 75% in 2008. A large debt load and negative free cash flow generation are the most obvious factors holding back the company's dividend growth potential. Regardless of whether or not either of these metrics gains positive momentum in the near term, we think it would behoove management to hold off on growing its quarterly payout for the foreseeable future.

Our published Dividend Cushion ratio for Lennar is -22.5 (NMF) with a Dividend Track Record of Risky.

MDC (MDC)

Though we're not particularly fond of MDC's balance sheet, it is one of only two homebuilders to keep an investment grade credit rating through the housing downturn.

MDC's business consists of two primary operations: homebuilding and financial services. The firm builds and sells primarily single-family detached homes, and its financial services operations provide mortgage financing and title insurance. It has been building new homes under the name 'Richmond American Homes' for 40+ years.

After a half-decade of uneven price retreats, declining interest rates, and a whole lot of litigation, the US housing market appears to finally be on solid footing. A rising tide should lift all boats, and consolidation is heating up.

Though we're not particularly fond of MDC's balance sheet, the company is one of only two homebuilders to maintain an investment grade credit rating through the housing downturn. This is quite an accomplishment. MDC has ~$1 billion in liquidity as of the end of the second quarter of 2017 and recently has had no problem refinancing debt.

Management's interests are tied to those of the shareholders. Chairman and CEO Larry Mizel and President and COO David Mandarich have 75 years' combined experience at MDC and together own more than 20% of MDC stock. We like that the executive suite has skin in the game.

The company boasts an industry-leading dividend yield, but we don't particularly like the homebuilding industry. We'll stick with companies in the Dividend Growth portfolio for income generation.

Our published fair value estimate range for MDC is $21-$35 per share, with a Valuentum Buying Index rating of 6 and an Economic Castle rating of Unattractive.

MDC boasts an industry-leading dividend, but the homebuilding industry is not necessarily conducive to strong dividend payers. The firm pulled 2013 dividends into 2012.

MDC not only was able to survive the housing downturn during the last decade, but it also continued to pay a consistent annual dividend of $1.00 per share throughout the Financial Crisis. MDC was also able to maintain an investment grade credit rating throughout the credit crunch. The company prides itself on its ability to return above industry-average capital for its investors. MDC's annualized dividend yield has been roughly more than double the next highest yield in the homebuilding industry at recent price levels. However, we think dividend growth should not be a priority of management when considering the firm's poor Dividend Cushion ratio.

MDC operates in a highly cyclical, capital intensive industry whose health relies on a variety of variables outside of the control of firms in the space. Nevertheless, the company has been a consistent dividend payer. MDC paid an accelerated dividend of $1.00 per share at the end of 2012 in lieu of paying quarterly dividends in 2013 because of the uncertainty of changes to tax rates. A combination of a material debt load on its balance sheet and less than ideal free cash flow generation lead to MDC’s poor Dividend Cushion ratio, and we think improving these areas should take priority over dividend growth.

Our published Dividend Cushion ratio for MDC is -2 with a Dividend Track Record of Healthy.

Meritage (MTH)

We like Meritage's resiliency.

Meritage Homes is a builder of single-family detached homes. The firm primarily builds in high-growth regions of the western and southern US. The company has a reputation for distinctive style and quality construction and is setting the standard for energy-efficient homes. The company was founded in 1985 and is based in Scottsdale, Arizona.

The company continues to broaden its geographic footprint (it has added ~7 new markets since 2011), and it has deepened its penetration in key markets such as Raleigh, Charlotte and Tampa. Backlog fell in terms of both units ordered and total value in 2016 before rebounding slightly in the first half of 2017.

Having navigated through a housing downturn, investors shouldn't expect homebuilder balance sheets to be pristine. Meritage's total outstanding debt is more than 6 times its cash and cash equivalents as of the end of the second quarter of 2017. As long as credit markets cooperate, we don't expect any liquidity problems at the company, however.

Meritage's financial performance has been a sight to see since the depths of the Great Recession in 2009. Revenue has more than doubled and its adjusted homeclosing gross profit margin has expanded to 19% from ~14% since then. We like the firm's resiliency, though it is due in part to its cyclical industry.

Though the housing market is on much more stable ground, we cannot forget about the inherent cyclicality of the homebuilding industry. New Meritage homes troughed at 3,383 in 2010 before rebounding to nearly 7,400 in 2016.

Our published fair value estimate range for Meritage is $36-$60 per share, with a Valuentum Buying Index rating of 6 and an Economic Castle rating of Unattractive.

NVR Inc (NVR)

A very important aspect of NVR's business model is its emphasis on liquidity and minimizing risk.

NVR's primary business is the construction and sale of single-family detached homes, townhomes and condominium buildings. Roughly 30%-40% of its home settlements occur in the Washington, D.C. and Baltimore, MD metropolitan areas. The company sells homes under four brand names: Ryan Homes, NVHomes, Fox Ridge Homes, and Heartland Homes.

Founded in 1948, Ryan is its oldest homebuilding operations. NVHomes has earned a reputation for quality, while Fox Ridge is one of the largest builders in Nashville, TN. Heartland is a leader in Pittsburg, PA.

A very important aspect of NVR's business model is its emphasis on liquidity and minimizing risk. Unlike its homebuilding peers, the firm avoids developing land and speculative building. The firm uses 'option' agreements that enable it to purchase lots on a just-intime basis, after it has sold homes on these lots. This strategy came in handy during the downturn.

The underproduction of homes since 2008 has created pent-up demand, and the company has gained share from weakened private homebuilders. Stronger general economic conditions, including lower unemployment, modest wage growth, and general consumer confidence are driving demand as well.

Though we generally like NVR's lower-risk business model, the housing industry is not only cyclical but competition is fierce. Investors should be cognizant that changes in economic stimulus and rising interest rates are key risks.

Our published fair value estimate range for NVR is $1562-$2468 per share, with a Valuentum Buying Index rating of 4 and an Economic Castle rating of Attractive.

Pulte (PHM)

PulteGroup has an unmatched presence in the active adult market, a buyer group that remains one of the largest and most affluent, through Del Webb.

PulteGroup is one of the largest homebuilders in the US. Through its brands, which include Pulte Homes, Del Webb, and Centex, the firm offers a wide variety of home designs, including single-family detached, townhouses, condominiums, and duplexes. The firm was founded in 1950 and is headquartered in Atlanta, Georgia.

The company has an unmatched presence in the active adult market through the Del Webb brand. This buyer group remains one of the largest and most affluent, with almost 40% of Del Webb buyers paying cash for their homes. The US population over age 55 continues to grow.

Pent up housing demand has been accruing for years, and new home inventory is limited, making an environment conducive to housing price improvements (as a result of simple supply/demand dynamics). Though we acknowledge the concept of 'shadow inventory'—sellers currently without a 'for sale' sign in their front yard—overall inventory trends continue to move in the right direction.

PulteGroup has four priorities for capital allocation: 1) invest in core business to maintain or grow relative market share; 2) growing its dividend; 3) opportunistic M&A; 4) routinely return excess capital to shareholders via share buybacks. We like the firm's focus on improving ROIC in M&A.

After a half-decade of uneven price retreats, declining interest rates, and a whole lot of litigation, the US housing market is continuing its recovery. 2016 new home sales increased 12% over 2015 levels, but remain nearly 15% below the 50-year average.

Our published fair value estimate range for Pulte is $20-$33 per share, with a Valuentum Buying Index rating of 7 and an Economic Castle rating of Attractive.

Toll Brothers (TOL)

Toll Brothers is focused on the luxury demographic, but it continues to diversify the type of properties its offers.

Toll Brothers builds and arranges financing for detached and attached homes in luxury residential communities. The firm caters to move-up, emptynester, active-adult, age-qualified and second-home buyers. The company is the US' leading luxury home builder. It was founded in 1967 and is headquartered in Pennsylvania.

Toll continues to diversify its product offerings. Single family homes have fallen to less than 60% of units delivered as of fiscal 2016 from nearly 90% in fiscal 2000. Meanwhile attached and age qualified units have risen to 18% and 21%, respectively, from 10% and 1%.

Pent up housing demand has been accruing for years, and new home inventory is limited, making for an environment conducive to housing price improvements (as a result of simple supply/demand dynamics). Though we acknowledge the concept of 'shadow inventory'—sellers currently without a 'for sale' sign in their front yard—overall inventory trends continue to move in the right direction.

Toll estimates that the total estimated shortfall of housing starts from the period 2008-2016 was 6.6 million. That equates to an annual shortfall in production of ~735,000 new homes, providing significant opportunities for the homebuilding group as a whole moving forward.

Toll's main competitors are small private builders, not the large public builders. For example, its average home price in fiscal 2016 was ~$847,700, significantly higher that of its publicly-traded peers. The company is laser-focused on the luxury demographic.

Our published fair value estimate range for Toll Brothers is $28-$46 per share, with a Valuentum Buying Index rating of 7 and an Economic Castle rating of Attractive.

Back to top

Previous | Next