

## U.S. Homebuilding

### Atlanta Call Transcript: Healthy Demand Supported by Millennials Buying in the 'Burbs

#### Equities

Americas  
Home Construction

**Susan Maklari**

Analyst

susan.maklari@ubs.com

+1-212-713 7971

#### Volumes Expected to be +15% YOY in 2016

As we progress through the 2016 spring selling season, we recently hosted a call with Eugene James of Metrostudy to get an on the ground perspective of Atlanta. For the last four quarters ending 1Q16, starts were +18% year over year to ~20,000 units. Further, closings rose 18% to 18,100 units. Although starts here are not expected to reach the prior peak (~60,000 in 2006), our expert believes that builders can get to 30,000 over the next several years, and forecasts activity to be +15% for 2016 and +10-12% in 2017.

#### Transition to Peripheral Submarkets a Reality

Broadly, there has been talk about the price differential between the new and existing home markets and what it means for the recovery, as affordability has pushed the first time and entry level segments to existing homes. That said, our expert noted that the median price for a new home in Atlanta is ~\$270,000 versus a comparable resale home at ~\$250,000, as builders move to more peripheral locations. Given the narrowing gap between the two, we are seeing demand among first time millennial buyers who are willing—and able—to purchase a newly built home further out in these locations. Additionally, as builders recognize this, they are beginning to tailor their product offering and locations.

#### Don't be Surprised If We See Further Consolidation in Atlanta

Historically, Atlanta was a highly fragmented market dominated by private builders. This has changed over the last few years, though, as publics have looked to gain share. For example, D.R. Horton acquired Crown Communities in 2014 and is currently the top builder in the area. Additional consolidation here includes Pulte's purchase of John Weiland Homes as well as Taylor Morrison of JEH Homes last year and Acadia Homes this year. Given the supportive supply and demand dynamics, our expert wouldn't be surprised to see further M&A activity over the next twelve months.

#### Valuation: Our PTs are Based on a 50/50 Blended 2017E P/E & P/BV

Our PTs are based on a blended valuation using an avg. of 8x our 2017E EPS and 1.3x our 2017E BVs. The stocks trade at 8.8x our 2017E EPS and 1x our 2017E BVs. Our top picks in the group are TOL, LEN and PHM.

# U.S. Homebuilding

UBS Research THESIS MAP MOST FAVORED

LEAST FAVORED

Toll Brothers, Lennar, Pulte

Meritage, KB Home

## PIVOTAL QUESTIONS

### Q: How much will new home sales rise in 2016?

We look for 10-15% growth this year—with greater likelihood it will be at the lower end of this range—given constraints around land and the availability of labor as well as the macro environment.

### Q: Will the rate of home price appreciation slow?

We look for prices to rise in the mid-single digit range, reflecting: 1) positioning of new communities to better target entry level and first time buyers as well as volume gains; 2) difficult comparisons, as limited inventory allowed for greater levels of appreciation earlier in the recovery; and 3) increased activity in more moderately priced areas.

### Q: Will the multiple compression witnessed year-to-date remain a factor in the stocks?

Yes, as we go further in time through the broader cycle, we look for this to persist. As would be expected, historically, as the rate of unit growth decelerates and volumes approach peak levels, multiples trend lower.

## WHAT'S PRICED IN?

### Current valuations are pricing in moderating growth as we approach peak levels of activity:

As we enter the fifth year of the recovery—and with visibility remaining limited and greater risks to macro growth—concerns around moderating rates of unit expansion have risen. This has been furthered as the builders increasingly reduce their risk appetites as it relates to land investments and, in exchange, are accepting lower margins and returns. Based on current levels, we believe the stocks are pricing in growth of new home sales of ~10% for 2016.

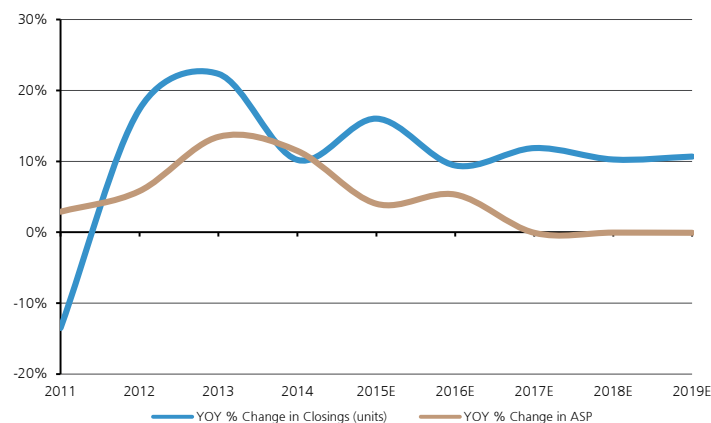
## UBS VIEW

**Greater participation among entry level and first time buyers will drive further gains:** We expect activity in the housing market will continue to expand as the entry level and first time buyer segments gradually re-emerge, a trend that is likely to play out over the next 18-24 months, giving us confidence in our longer term view.

## EVIDENCE

**UBS Evidence Lab suggests intent to buy, especially among millennials, is improving:** Our [Housing Intentions Survey through 2015](#) has shown a notable increase among millennials looking to buy a home, with 29% of this cohort intending to purchase up from the mid-20% range. Further, reflecting their confidence in the continuation of the recovery, the public builders have increasingly allocated capital to share repurchases, especially as valuations remain under pressure.

### We expect volume growth will exceed pricing as we move further in the recovery



Source: Company reports and UBS estimates

## Summary of Conditions

The Atlanta housing market continues to be encompassed by limited supply in core submarkets and strong demand that is expected to persist for the next few years. Given this, construction has been gradually expanding to more peripheral locations and targeting entry level buyers. This is in line with our broader thesis that the recovery is in a period of transition as volume growth begins to accelerate while pricing power is more limited. We provide additional color below:

- Employment growth has been steady in Atlanta, averaging ~3% annually for the past few years, with expansion across a wide variety of sectors. Further, demand should get additional support from job relocations and active adults/retirees moving into the area.
- For the last four quarters ending 1Q16, starts were +18% year over year to ~20,000 units. Further, closings rose 18% to 18,100 units. Although starts here are not expected to reach the prior peak (~60,000 in 2006), our expert believes that builders can get to 30,000 over the next several years, and forecasts activity to be +15% for 2016 and +10-12% in 2017.
- Broadly, there has been talk about the price differential between the new and existing home markets and what it means for the recovery, as affordability has pushed the first time and entry level segments to existing homes. That said, our expert noted that the median price for a new home in Atlanta is ~\$270,000 versus a comparable resale home at ~\$250,000, as builders move to more peripheral locations. Given the narrowing gap between the two, we are seeing demand among first time millennial buyers who are willing—and able—to purchase a newly built home further out in these locations. Additionally, as builders recognize this they are beginning to tailor their product offering and locations.
- Atlanta currently has 104,000 vacant developed lots, most of which are located in outlying locations where demand is just starting to materialize. The existence of these parcels offers builders room to expand at lower price points in future years, targeting first time buyers. While total VDLs represent 63 months of supply, looking at the 5 core counties in Atlanta, this drops to 28 months.
- Historically, Atlanta was a highly fragmented market dominated by private builders. This has changed over the last few years, though, as publics have looked to gain share. For example, D.R. Horton acquired Crown Communities in 2014 and is currently the top builder in the area. Additional consolidation here includes Pulte's purchase of John Weiland Homes as well as Taylor Morrison of JEH Homes last year and Acadia Homes this year. Given the supportive supply and demand dynamics, our expert wouldn't be surprised to see further M&A activity over the next twelve months.

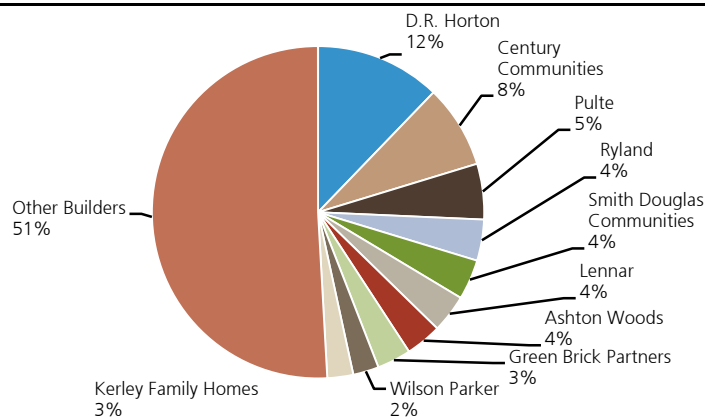
[Please click here for our Atlanta preview note that was published prior to the call.](#)

# Builder Presence: Operating Stats

## Atlanta

With approximately 12,100 new homes closed in 2014 (based on data collected by Metrostudy and reported as part of Builder Magazine's "Local Leaders" series), the Atlanta/Sandy Springs/Roswell metropolitan area ranked as the 3<sup>rd</sup> largest housing market in the country. In terms of share held by the top builders, this MSA is more fragmented relative to other major markets. In each of the 50 largest housing markets in the US, the top ten builders were responsible for approximately two-thirds of new home closings in 2014, which compares to 49% in Atlanta.

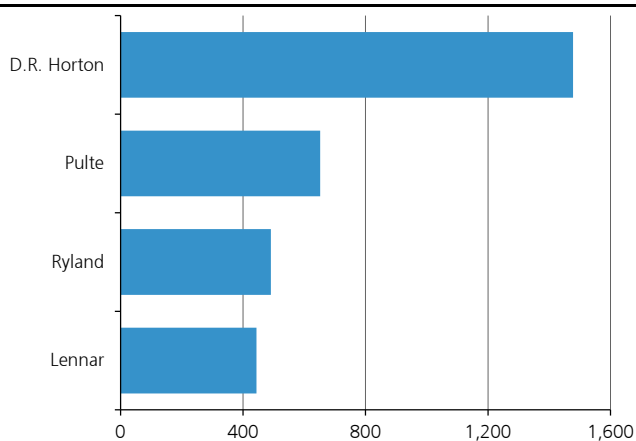
**Figure 1: Share of 2014 Atlanta Area Closings, by Builder**



Source: Builder Magazine (Metrostudy)

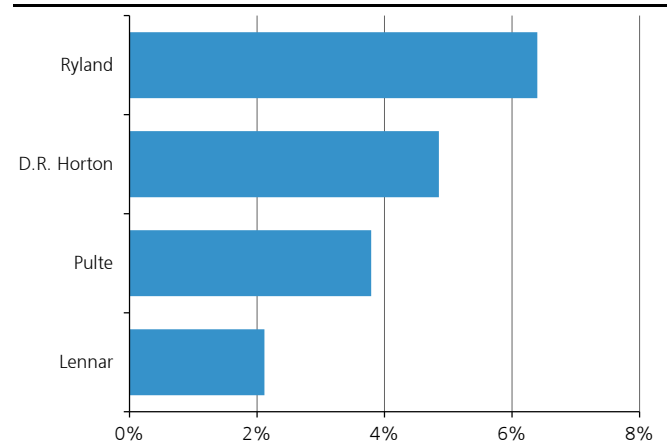
For companies in our coverage universe, D.R. Horton closed the largest number of homes in Atlanta in 2014. However, relative to total company closings, Atlanta was a more important market for Ryland (now part of CalAtlantic following the merger of equals with Standard Pacific).

**Figure 2: 2014 Atlanta Area Closings**



Source: Builder Magazine (Metrostudy)

**Figure 3: 2014 Atlanta Share of Total Company Closings**



Note: Calendar year closings obtained from Builder Magazine. UBS divides these closings by closings per company reports for the four fiscal quarters most closely coinciding with the 2014 calendar year.  
Source: Builder Magazine (Metrostudy) and company reports

# Conference Call Transcript

*Below, we present the transcript from our call with Eugene James of Metrostudy, a provider of market information on real estate development and new home construction. It has been edited for clarity.*

**Susan Maklari:** Welcome to everyone that has dialed in this morning. We will be getting an update on Atlanta, especially through the selling season. With us today is Eugene James with Metrostudy. With that Eugene, I'll turn it over to you.

**Eugene James:** Thank you Susan. First and foremost I have to talk about the employment market since that's a primary driver for housing. That's good news as overall Atlanta's been experiencing about 3.2% growth each month for the past 36 months. In March, it was up 3% year over year. Atlanta is the 9<sup>th</sup> largest MSA by population, with 5.7 million people in the region. We're expecting even more to relocate here as the economy continues to improve nationally, especially from areas such as New York, New Jersey, Washington D.C. and even Florida. Currently, based on single-family permits and housing starts, Atlanta is the third largest housing market in the country, behind Dallas and Houston.

We ended March 2016 with 77,000 net new jobs. If you look further back over the past 24 months, you'd see we have been averaging around 86,000/month. Trade and transportation is the largest sector, given the size of Hartfield Airport. Professional and business services is the second largest. The big takeaway related jobs is that Atlanta is not too heavily concentrated in any one area. It's well spread out and diverse so even if there was a slowdown in one area, it shouldn't impact the overall market too terribly.

From an unemployment rate perspective, we're at 5.2%, which is above the national average. As far as the Federal Government is concerned, Atlanta is made up of 29 counties. But, there are five core counties where most of the construction activity takes place. In those areas, the unemployment rate is hovering in the lower 4% range. That's where the bulk of the demand has been for new construction and that's where builders are having a hard time keeping up with the demand.

Let's talk about the apartment market for just a moment. It has been red hot all over the country just like it is here. Vacancy rates remain low at around 5%. There has been some discussion lately about perhaps having too many units under construction, particularly in the core sections such as Buckhead and Midtown. I'm hearing some developers are saying they're going to pull back and not start any new units until the ones that are under construction get absorbed.

I've given this some thought and don't believe we are overbuilding for the following reasons. First, lots of people are coming to Atlanta to go to college. Typically, many would leave the region and go back home, but with the job market as solid as it is, more graduates are staying put. They're going to need a place to stay. In addition to that, new construction and inventory has been low for a very long time. As a result, I see the existing apartments that are delivered getting absorbed.

Speaking of resale, let's talk about that a little bit. Once again, the resale inventory is very low, well below normal levels. This is a little odd since homeowner equity has improved dramatically for almost every portion of metro Atlanta. We're hovering around a three-month supply. Traditionally, six months would be considered about more normal.

I think during the housing depression, there were institutional investment groups—and many smaller private ones—that came into the region and purchased tens of thousands of resale units below replacement cost. Now, all those houses are rentals and the returns are very good. There's no pressure at all to sell them. In the past, you'd see maybe a five or seven-year cycle for housing turnover. Well, they're not going to turn over any more. Perhaps we need to start thinking about a new normal for month's supply for resale and I don't know what that is. Maybe it should be closer to four or five months.

Months' supply of resale below \$250,000 is around two months. This is causing a lot of stress for people looking for a home to purchase. It is not such good news for the builder who really needs that consumer to sell his existing house in order to move up into a new home.

For the most part when houses hit the MLS, they are selling quickly. In fact, we're back to seeing pocket listings where an agent will stick a sign in the yard and won't put it in the MLS. The house sells quickly with very little marketing on behalf of the agent. In March 2016, the median closing price for resale homes, including REO, was \$173,000. That's a 3.5% increase year over year. Last year, it was \$167,000. REO transactions are making up a much smaller percentage, down to 15%, of total closings. Last year, they made up 22% of the total.

Since many of the resales are much smaller than the typical new home being built, I like to try to come up with a better comparison of the two. Taking out resales that were less than 2,000 square feet, the median sales price comes in at \$250,000. That's only an 8% difference between new versus the larger resale homes. I think that's a far better comparison versus what most people typically hear about when they look at things on a more macro level.

Let's jump into the new home trends that are taking place in Atlanta. Builders constructed about 20,000 new units over the past 12 month ending March 2016. Starts overall were up 18% year over year. Last year, they were closer to 17,000 units. Closings were also up by an equal amount at 18%, coming in at 18,100 new units. What has been interesting, though, is that starts have remained slightly ahead of closings for the past three plus years. That's a good sign, as builders don't seem to be able to quite keep up with demand.

The median new home price in the 1st quarter of 2016 was \$267,800. The one thing I no longer do is look at the percentage change year over year. It won't make sense because we are seeing a lot more new construction in further out locations, let's call them former C and D areas. I think the "C"s are the new "B"s. That's where we're seeing activity having picked up.

Public builders such as D.R. Horton will do quite well now that demand has picked up for that first time homebuyer. D.R. Horton, by the way, is the #1 builder in Atlanta with a very large market share of 13% of all closings. The #2 builder is Century Communities at 6.2%. You can see quite a spread between #1 and #2. Other top 10 builders here include Pulte at #3 with 4.8%, Lennar is #5, Taylor Morrison is #6 and CalAtlantic is #10 with a 2.3% market share.

Community count is something I would also like to touch here, which is rather interesting. The community counts have gone flat here lately, with about the same number of stores opening up as those that closed out. Our field researchers counted about 16,000 lots that are currently in some stage of development and

we think can be delivered by the end of 2017. Of course, these new parcels are in the core markets, almost entirely in five or six counties, where supplies are lowest.

Let's talk about some recent trends that we're seeing in Atlanta. I'll touch on the infill market, which is going quite well. In fact, I have to call it hot. Overall, this is still a very small portion of the overall new home market. It will grow as demand continues to expand and more people want to move into town. But, it will remain a much smaller share if for no other reason than the prices are much higher.

We also expect first time consumer demand to continue to grow for the next three years. Any builder, whether they're public or private, that focuses on delivering product for that homebuyer will do well. The active adult population is growing here in the region. Pulte stands to do well with their Del Webb product line.

Let's talk a little bit more about lots. Atlanta still has more finished parcels than any other market in the country. We currently have 104,000 vacant developed lots. That's down from a record high of 150,000 back in 2010. Often, people like to measure the health of the finished market by looking at the month's supply. We'll talk about that, but I have to throw in some caveats. Currently, using traditional calculations, the overall month's supply for vacant developed lots in Atlanta is 63, which seems enormous. It is lower in the northern portions of metro Atlanta, where currently 70% of all the building is taking place. In North Atlanta it is at 46 month and in the Southern area, it's 122 months. Most of the building is taking place in just 5 of the 22 county regions that we cover. If you start looking at the month's supply for those five core counties, it drastically declines to 28 months. Going one step further, the month's supply for vacant development lots in communities where there's at least some type of activity taking place, it falls down to just 19 months. You have to be careful when you're looking in Atlanta as it can be extremely misleading.

With the increase in labor and overall development costs land prices have risen. We will see future new homes delivered 10-15% higher to compensate for those additional costs.

Cancellation rates seem to be very low based on what builders are sharing with us. We expect to see them remain at normal levels. Regarding our inventory of new homes, Atlanta is perhaps still is the largest spec market in the country. We're estimating around 40% of all new construction starts will be in specs. Another 20-30% of homes currently under construction turn into pre-sale before the house is completed. Once again, it's a sign of how strong the overall new home market is.

We like to measure the health of our inventory by looking at the months' supply for the just the finished vacant inventory. Today, it is at 2.9 months' for finished vacant homes. Atlanta's norm used to be around a 3-3.5 months' supply, so we are at or below what's considered normal levels. With regard to foreclosures, they're no longer a threat, as we're back to normal levels of activity.

I'll wrap up by sharing just a few other thoughts about the market. Private builder financing has gotten a lot better as it is a lot easier for them to obtain traditional credit. With the abundance of finished lots in the further out markets, the first time homebuilder will continue to do well. If there's anything that concerns me the most, it's probably the resale housing market. It feels like prices may be getting a little bit frothy because of the low supply and high demand. Those buyers that have to have a house and are a little bit more desperate are making offers above asking price. Once again, that's more good news for builders, especially when I

think about those that are far more disciplined and not so prone to jack their prices up. We may see resale prices have to go through some type of an adjustment, perhaps 12 months from now.

With that, I'll wrap up my prepared remarks. I'm certainly open to answer any questions you have at this time.

**Susan Maklari:** You mentioned that you're seeing more activity in further out areas. That seems somewhat in contrast to the broader trend that we've been hearing about, which is that a lot of first time and entry level buyers want to be in urban, closer in types of areas. How do we think about that contrast?

**Eugene James:** Sure, younger folks and millennials want to live closer in, except they can't afford it as the in town markets are the most expensive overall. They're recognizing the advantages of being a homeowner but are being forced to go further out, so that's part of the answer. Once again, the supply of homes in the new and resale markets in the closer in areas is just not there. We have far more demand than the supply of homes overall. Thus, you do what you have to do, which is live a little further out.

**Participant Question:** When you say core counties, do you include Forsythe and Cherokee in that? Building activity and single-family housing is absolutely going ballistic up there.

**Eugene James:** You are correct and yes, I am. In fact, I think at one point in time, Forsythe County had surpassed our traditionally largest county, which was Gwinnett. Forsythe is the #2 market these days in terms of activity. What is interesting about Forsythe is that you can divide it into two pieces, a north versus south. Prices on the south side are through the roof. Today, we're seeing a lot more activity in the northern portion of Forsythe, which at one point in time I would have considered D and F locations.

**Participant Question:** Previously you talked about having a lot of vacant developed lots. How does that square with the fact that anecdotally we hear that the builders are saying they don't have enough lots?

**Eugene James:** I was straining for the listeners to be careful and not look at just that one months' supply number, which is a 60 months. When you start looking at the areas where builders are primarily building, it is much lower. There are certain places where the months' supply is 10 or 12 months, a severe shortage of finished lots. This also explains why we are seeing parcels trying to get delivered in those core areas, but it's just a slow process.

It's the tale of two Atlanta's, if you will. There's the Atlanta where there is an oversupply of lots, which is in the further out portions of town versus a shortage where the bulk of that activity is taking place today.

While we're waiting on the next question, I probably should mention how Atlanta has changed with regards to the top 10 builder share. I think it's an illustration of how the region has changed. Today, the top 10 builders account for 44% of all closings. Compare that to how Atlanta used to look back in 2008 or 2009, when the top 10 had about a 20-22% share. I think this is going to be the new norm with the top 10 holding a larger piece, which is closer to how it looks in the other major metros throughout the country.



**Susan Maklari:** That's interesting, especially as Pulte bought John Wieland Homes earlier this year. Are you seeing more builders looking to buy smaller privates?

**Eugene James:** Yes. If you recall, I was sharing the market share for D.R. Horton versus the next closest competitor. Well, D.R. Horton drew their market share by buying the largest builder in Atlanta—Crown Communities. Then, Century purchased the former #2 builder, which is why they're as big as they are. Pulte just purchased John Weiland, which helped grow their presence rather rapidly. Taylor Morrison is on the list; they've made two private builder acquisitions here rather recently, JEH Homes and the former Acadia Homes. It's a great way for builders to grow and I wouldn't be surprised if we see another deal occur over the next 12 months or so.

**Susan Maklari:** You also mentioned that Atlanta is a very large spec market. Something that we've seen is a lot of builders have tried to go to a more of a build- to-order approach through the recovery. Are you seeing them loosen up on that and get back to perhaps more of a spec model in Atlanta?

**Eugene James:** I think Atlanta did move more towards build-to-order as throughout the rest of the country—less spec and more pre-sales. But, now that demand is picking up, especially for that first time homebuyer, builders are trying to put more specs on the ground. They almost need to for that segment. First, there's very little resale available. Next, when those first time homebuyers go into a community, they want and need to buy right now. If you don't have a product ready for them, they're not willing to wait four or five months for you to deliver a house. They're going to go somewhere else or try to find an existing home nearby.

I think we'll see spec inventory start to grow the way it used to. I don't think it'll get back to the peak, but I do anticipate builders putting more specs in their communities so when consumers walk in they have something to offer right away.

**Susan Maklari:** You talked about the very strong growth rate that Atlanta's seen. How do we think about that as we move through 2016? Can it be sustained? Do you expect it to incrementally slow? How do you think about the level of starts this market should get back to over time?

**Eugene James:** First of all, everything that I believe is contingent upon jobs and that market is looking good. The more construction you see, the more permanent jobs get created. I also look at historical trends with regards to in-migration. The more the U.S. economy heals and grows, the better off Atlanta will be versus many other cities. We'll probably start seeing more people relocate back here with either active adult or retirees moving into the area. Anecdotally speaking, over the last two weeks in casual conversations, I've discovered people that have come here for jobs in healthcare. It seems like we're attracting people in all sectors from outside of the region.

We are currently at a 20,000 annual starts pace. I suspect we'll see our starts increase another 15% by the end of 2016. Going into 2017, I think it begins to slow a little, but probably to around 10-12%. I think there is plenty of room to increase our overall annual starts and the new norm for Atlanta will be around 30,000 starts. That said, it's going to take years to get there we're only increasing 10-15%/year. There's a great opportunity for the builders here in Atlanta.

**Susan Maklari:** On that note, Eugene, we'll wrap it up there. Thank you for the overview and thank you to everyone that has dialed in today.

### **Valuation Method and Risk Statement**

The primary risk facing homebuilders currently is that the recent improvements experienced slow or reverse, driven by 1) a weaker macroeconomic backdrop and the related lower level of job creation or 2) the impact from recent increases in mortgage rates. Additional risks include increased costs for either land, labor or materials and the potential for the more limited availability of mortgage financing to negatively impact demand.

Our PTs are based on a blended valuation using an avg. of 8x our 2017E EPS and 1.3x our 2017E BVs.

## Required Disclosures

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12-Month Rating	Definition	Coverage <sup>1</sup>	IB Services <sup>2</sup>
Buy	FSR is > 6% above the MRA.	49%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	26%
Sell	FSR is > 6% below the MRA.	14%	19%
Short-Term Rating	Definition	Coverage <sup>3</sup>	IB Services <sup>4</sup>
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 March 2016.

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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## Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
<b>KB Home</b> <sup>16</sup>	KBH.N	Sell	N/A	US\$12.61	13 May 2016
<b>Lennar</b> <sup>7, 16</sup>	LEN.N	Buy	N/A	US\$43.59	13 May 2016
<b>Meritage Corporation</b> <sup>16</sup>	MTH.N	Sell	N/A	US\$33.67	13 May 2016
<b>PulteGroup, Inc.</b> <sup>16</sup>	PHM.N	Buy	N/A	US\$17.98	13 May 2016
<b>Toll Brothers</b> <sup>16</sup>	TOL.N	Buy	N/A	US\$26.56	13 May 2016

Source: UBS. All prices as of local market close.

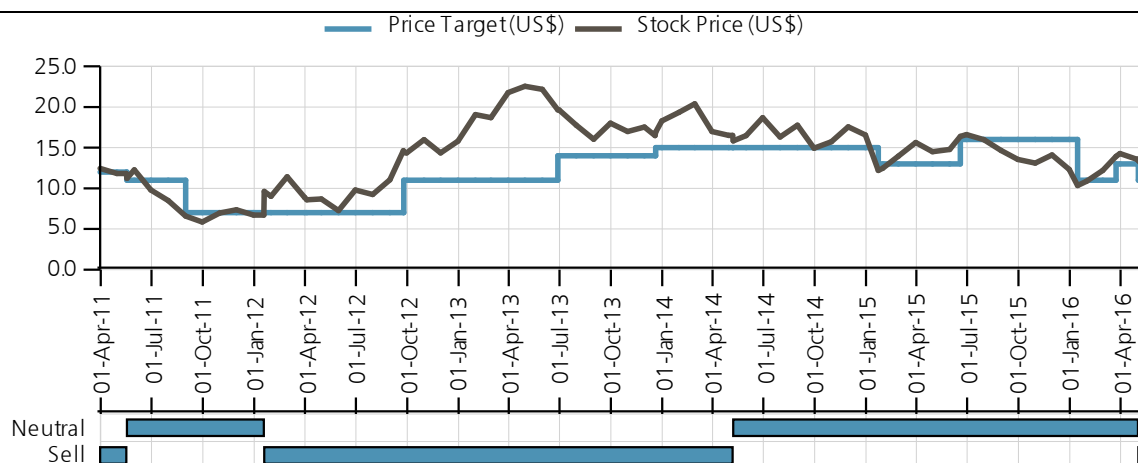
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.

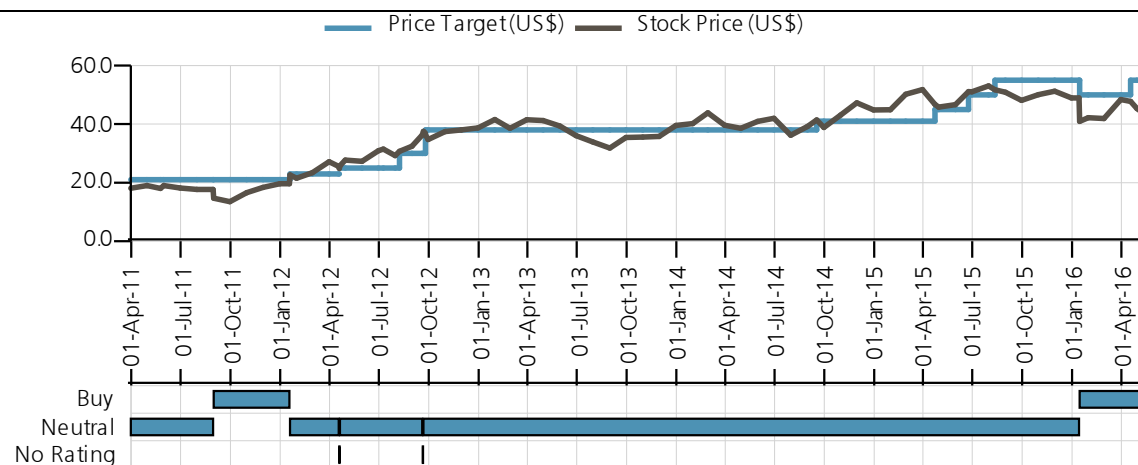
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### KB Home (US\$)



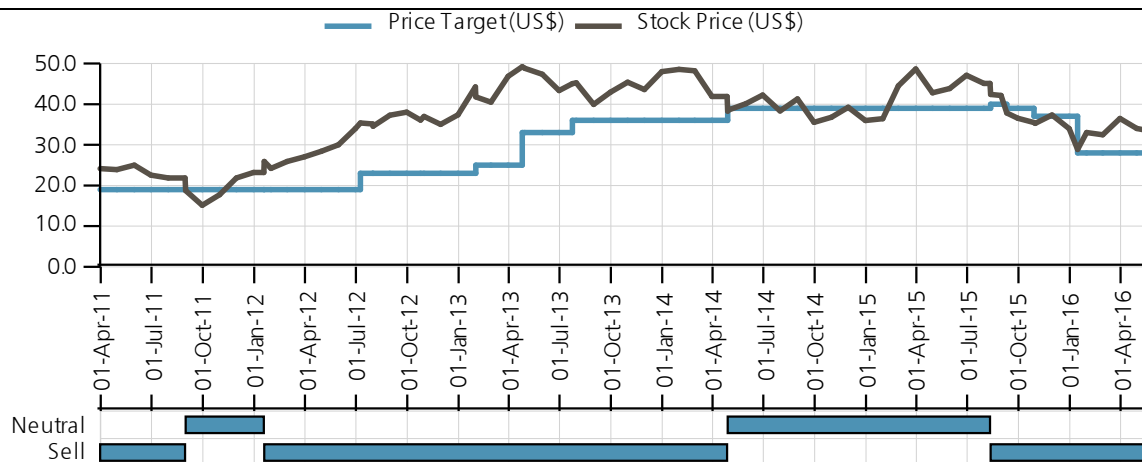
Source: UBS; as of 13 May 2016

### Lennar (US\$)



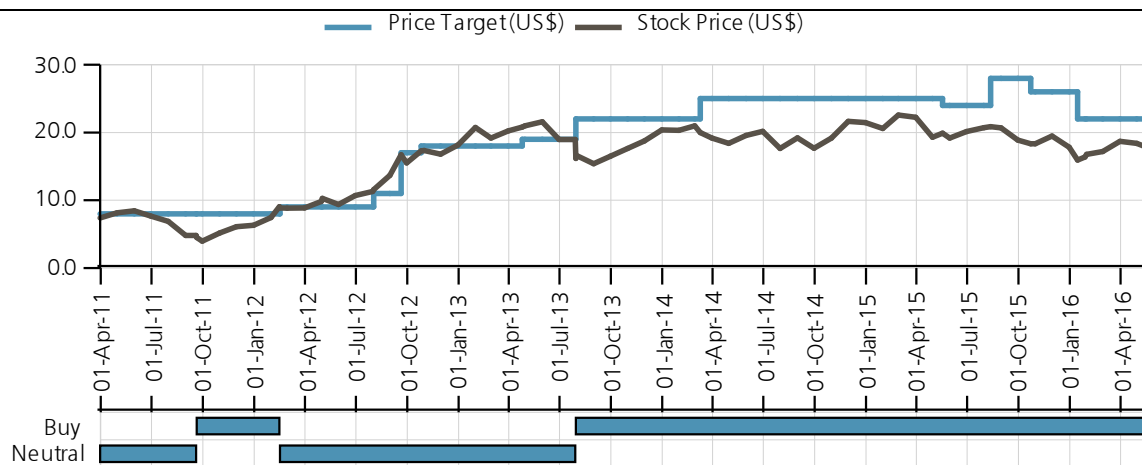
Source: UBS; as of 13 May 2016

## Meritage Corporation (US\$)



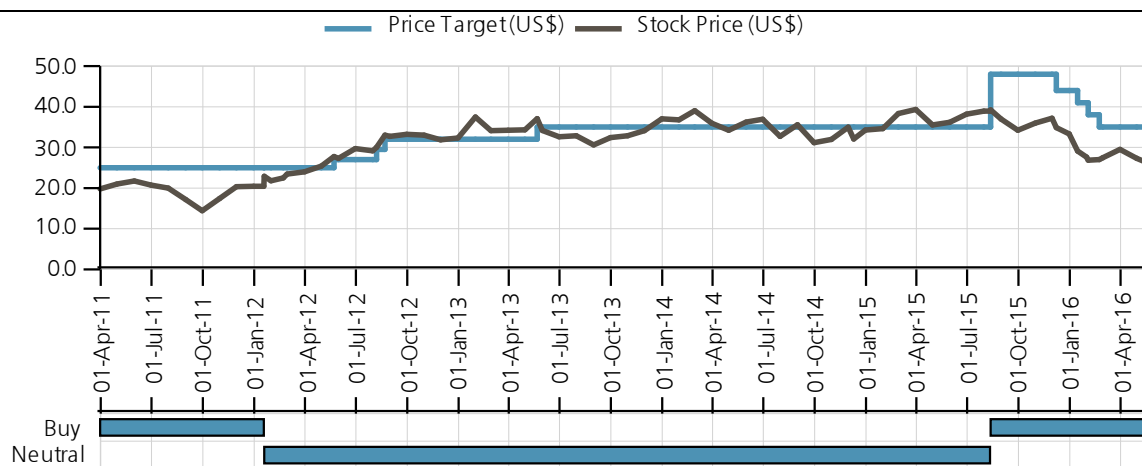
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## PulteGroup, Inc. (US\$)



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