

US Homebuilding

Catalyst: LEN Earnings in Focus

Equities

Americas
Home Construction

Susan Maklari

Analyst

susan.maklari@ubs.com

+1-212-713 7971

LEN Earnings and Macro Housing Data Scheduled This Week

This week, investors will be focused on earnings from Lennar (3/29 BMO). From a macro perspective, important data points include pending home sales (3/28 @ 10am) and S&P/Case-Shiller Home Prices (3/29 @ 9am). For Lennar, we expect EPS to come in at \$0.55, ahead of consensus of \$0.52. This quarter, we will be focusing on: 1) early reads on entry level demand trends this spring and if the company is starting to see buyers' interest pick up in more peripheral submarkets where affordability is less of an issue; 2) the tight conditions in the construction labor market and management's thoughts on if, and when, this might ease; and 3) conditions in Texas and to what extent incentives and discounting have played a role so far during the selling season.

Homebuilders Underperform Broader Market YTD

Last week, the HB stocks were -2.8% vs. the S&P 500 -0.7%. Year to date, the group is now down 5%, compared to the flat performance of the S&P 500. We continue to believe investors need to focus on company specific stories where EPS can grow at an accelerated rate even with a less supportive macro backdrop.

Re-Emergence of Entry Level Demand Will Drive Recovery

We believe the housing market is transitioning to more volume based growth, driven by the re-emergence of the entry level. The rate of home price appreciation will ease, in turn, as it is easier to match supply to demand in more peripheral locations. We look for this to play out over the next 18-24 months, giving us an optimistic outlook on housing broadly. That said, we believe some builders are better positioned than others. More specifically, we look for a differing rate and mortgage lending cycle versus historical norms as well as a relative maturing of millennials to be key trends.

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 8.6x our 2017E EPS and 1x our 2017E BVs. Our top picks in the group are TOL, LEN and PHM. We also highlight Buy-rated BZH.

The 10 Most Read Reports Over the Last 30 Days

[A Treasure Map for Housing Vol. 6](#)

[TOL: Key Takeaways Following Management Meetings](#)

[MHK 4Q EPS: Sweeping Up the Profits as Management Continues to Execute](#)

[MAS: Improving Demand Trends Support Upside](#)

[Las Vegas Call Transcript: Not A Mirage, ~10% Growth Expected in 2016](#)

[TOL F1Q EPS: Results Suggest Recovery Remains Intact](#)

[What You Need to Know About the Phoenix Housing Market](#)

[Catalyst: KBH Earnings and Dallas Expert Call](#)

[Catalyst: Phoenix Housing Market Expert Conference Call in Focus](#)

[Phoenix Call Transcript: Demand Persists Despite Limited Supply](#)

U.S. Homebuilding

UBS Research THESIS MAP MOST FAVORED

LEAST FAVORED

Toll Brothers, Lennar, Pulte

Meritage

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 new home sales growth of ~10% for 2016.

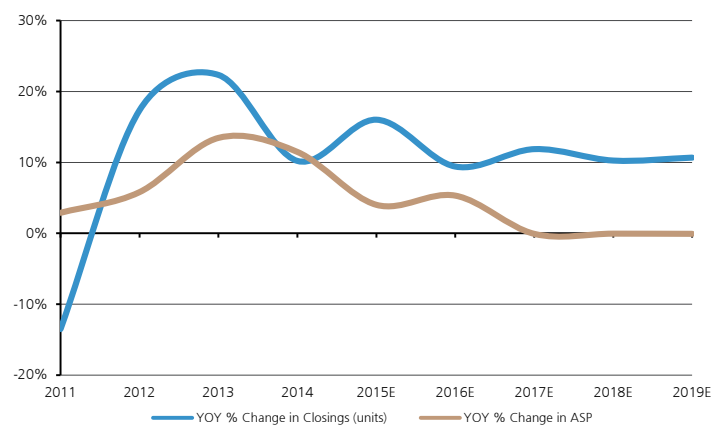
UBS VIEW

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

Figure 1: March/April Events

Monday	Tuesday	Wednesday	Thursday	Friday
28 Feb. Pending Home Sales (10:00)	29 LEN Q1 EPS (BMO) Jan. CoreLogic Home Prices (8:00) Jan. S&P Case-Shiller Home Prices (9:00)	30 Mortgage Applications (7:00)	31 Jobless Claims (8:30)	1-Apr
4	5	6 Mortgage Applications (7:00)	7 Jobless Claims (8:30) UBS Local Housing Market Conf. Call (11:00)	8
11	12	13 UBS Homebuilder University Conference Mortgage Applications (7:00)	14 Jobless Claims (8:30)	15
18 Apr. Housing Market Index (10:00)	19 Mar. Housing Starts (8:30)	20 Mortgage Applications (7:00) Mar. Existing Home Sales (10:00)	21 DHI Q2 EPS (BMO) Jobless Claims (8:30) Feb. FHFA Home Prices (9:00)	22
25 Mar. New Home Sales (10:00)	26 Feb. CoreLogic Home Prices (8:00) Feb. S&P Case-Shiller Home Prices (9:00)	27 Mortgage Applications (7:00) Mar. Pending Home Sales (10:00)	28 Jobless Claims (8:30) Q1 Housing Vacancy (10:00)	29

Source: Bloomberg, Bureau of the Census, Bureau of Labor Statistics, Conference Board, Federal Reserve Board, NAHB, U.S. Department of Labor, and UBS.

Key Macroeconomic Indicators

Mortgage Rates

For the week ended March 18, 30-year conforming mortgage rates were up 5 basis points sequentially but down 5 basis points year over year to 3.73%. The rate for one-year ARMs fell 9 basis points sequentially but rose 32 basis points year over year to 2.78%. Rates for 30-year fixed jumbo mortgages were down 4 basis points sequentially and 13 basis points year over year at 4.02%.

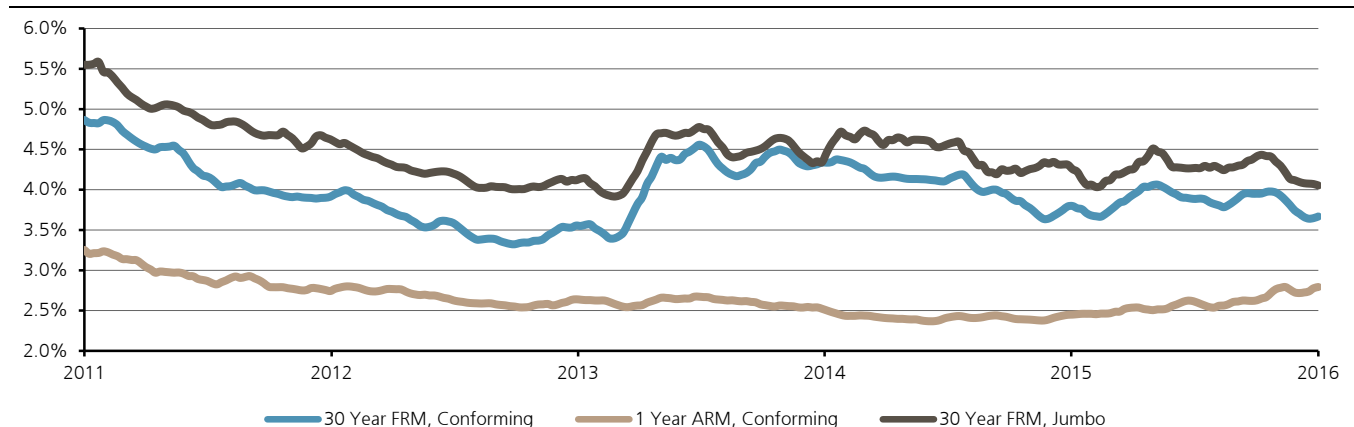
[Click here for our note on mortgage applications for the week ending March 18.](#)

Figure 2: Mortgage Rates

	Current	Last Week		Last Year		Historical		
	3/18/16	3/11/16	Change	3/20/15	Change	Average	Minimum	Maximum
30 Year FRM, Conforming	3.73%	3.68%	5	3.78%	-5	6.47%	3.31%	10.67%
1 Year ARM, Conforming	2.78%	2.87%	-9	2.46%	32	4.89%	2.35%	8.63%
30 Year FRM, Jumbo	4.02%	4.06%	-4	4.15%	-13	5.94%	3.88%	8.67%

Source: Freddie Mac, Bloomberg and UBS

Figure 3: Mortgage Rates – Last 5 Years (4wk Moving Average)



Source: Freddie Mac, Bloomberg and UBS

The Week Ahead: 3/28-4/1

LEN F1Q16 Earnings

On Tuesday (3/29), Lennar will release its first quarter earnings before the market open, with a call scheduled for 11:00am the same day. Our EPS forecast of \$0.55 is ahead of consensus of \$0.52. This quarter, we will be focusing on: 1) early reads on entry level demand trends this spring and if the company is starting to see buyers' interest pick up in more peripheral submarkets where affordability is less of an issue; 2) the tight conditions in the construction labor market and management's thoughts on if, and when, this might ease; and 3) conditions in Texas and to what extent incentives and discounting have played a role so far during the spring selling season.

We believe Lennar is among the best positioned builders in this recovery, given management's: 1) acumen at working through complex transactions; 2) efforts to effectively cut costs and simplify the business, and 3) pursuit of investments outside the core HB operations. Further, we note that the company was the first to gradually pivot its land strategy, responding to elevated asset prices by selectively choosing purchases while constraining growth. Finally, opportunities created through its ancillary businesses—including Rialto, its multi-family rentals, and FivePoint—represent potential further upside to results. In turn, the current valuation offers an attractive entry point.

Figure 4: UBS Estimates—LEN F1Q16

Homebuilding Activity	UBS Estimate	YOY Change (%)
Orders (units)	5,682	8%
Backlog (units)	7,649	14%
Closings (units)	4,590	7%
ASP (\$/000s)	\$336.1	3%
HB Revenues (\$/mn)	\$1,562.8	8%
Profitability	UBS Estimate	YOY Change (bps/%)
Gross Margin	22.8%	-60
SG&A % of HB Revenues	10.7%	-42
Estimated EPS	\$0.55	9%
Consensus	\$0.52	NA

Source: Company reports, Factset and UBS estimates

Recent Notes

[01.15.16 LEN: Upgrade to Buy](#)

[12.18.15 LEN F4Q EPS: Another Impressive Quarter; "There is No Try"](#)

[09.21.15 LEN F3Q EPS: Operating Acumen Continues to Impress](#)

[07.07.15 LEN: Five Point Filing Marks First Step in Transition](#)

Pending Home Sales

On Monday (3/28) at 10am, the pending home sales index for February will be released. UBS' Chief US Economist expects the index will increase 0.5% sequentially (-1.6% YOY), below consensus of +1.5% m/m.

S&P/Case-Shiller Home Prices

The January reading for the S&P/Case-Shiller Home Price Index will be released on Tuesday the 29th at 9am. UBS' Chief US Economist expects the seasonally adjusted composite 20-city index will increase 1% sequentially (+7.4% YOY). We'd note that the Case-Shiller Index is based on a three-month moving average (i.e., the January data is based on average prices for November, December and January).

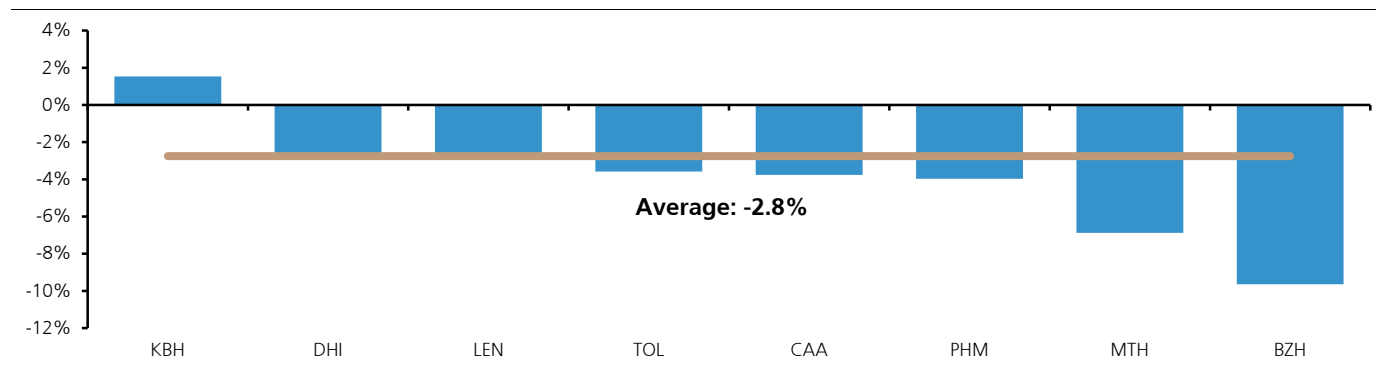
Stock Performance

For the week ended March 24, 2016, the homebuilder stocks were down 2.8% vs. the -0.7% performance of the S&P 500. Year to date, the group is now -5%, which compares to the flat performance of the S&P 500.

Despite the move in the stocks year-to-date, we believe operating fundamentals remain intact and the recovery is largely on track. More specifically, we look for volumes to increase 10-15% in 2016 while the rate of home price appreciation moderates, reflecting industry and economic conditions. At the same time, 2016 will be characterized by builders increasingly reducing their risk appetites as it relates to land investments and, in exchange, accepting lower margins and returns. Perhaps even more notably, we look for them to allocate capital to deleveraging and repurchases, especially if valuations remain under pressure.

Whereas we have focused our valuation on book value given the volatility in EPS, as results normalize we expect the correlation between P/E and starts will tighten, in line with historical norms. As such, we look for this to become more relevant. Therefore, we use a blended P/E and P/BV method based on our 2017 estimates, weighting each equally. Our price targets are based on 8x forward EPS and 1.3x on a book value basis.

Figure 5: Homebuilder Stock Price (Week-Over-Week % Change)



Source: Average is market-cap weighted based on the S&P 335 Homebuilders Index.

Source: Factset and UBS

Valuation Method and Risk Statement

The primary risk facing homebuilders is that recent improvements 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 land, labor or materials and potential for more limited availability of mortgage financing to negatively impact demand. Our price targets are based on a blended valuation methodology using a PE multiple on our 2017 EPS estimates and BV multiple on our forecasted 2017 book values.

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Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
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 December 2015.

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

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Beazer Homes ¹⁶	BZH.N	Buy	N/A	US\$8.25	24 Mar 2016
CalAtlantic Group Inc ¹⁶	CAA.N	Neutral	N/A	US\$31.76	24 Mar 2016
D.R. Horton Inc. ¹⁶	DHI.N	Neutral	N/A	US\$29.40	24 Mar 2016
KB Home ¹⁶	KBH.N	Neutral	N/A	US\$13.93	24 Mar 2016
Lennar ^{7, 16}	LEN.N	Buy	N/A	US\$46.35	24 Mar 2016
Meritage Corporation ¹⁶	MTH.N	Sell	N/A	US\$33.70	24 Mar 2016
PulteGroup, Inc. ¹⁶	PHM.N	Buy	N/A	US\$17.91	24 Mar 2016
Toll Brothers ¹⁶	TOL.N	Buy	N/A	US\$28.53	24 Mar 2016

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

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