U.S. Homebuilding
Houston Call Transcript: Entry Level to Be the Focus of 2016

Equities

Americas
Home Construction

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Slowing to Continue in 2016 Reflecting Macro Backdrop

As 2016 and the spring selling season rapidly approach, we hosted a call with Scott Davis of Metrostudy to get an on the ground perspective of Houston given the ever changing landscape of this important housing market. Although slower growth is expected in the quarters ahead, we maintain our view that performance will continue to differ by local geography and price point. We'd note, our expert believes we will end 2015 at 27,500 starts (down ~10% year over year) and expects 27,000 starts in 2016. Further, pricing is likely to pullback due primarily to product mix, though some declines are expected in select submarkets.

Price Appreciation Will Ease Closer to Historical Levels

Double digit price appreciation over the past few years has caused affordability to be a headwind. We'd note the median new home price is $276,000 compared to $211,000 for existing homes. That said, even with limited supply, the level of appreciation has moderated back toward the mid-single digit range, in line with historical norms. Some of this can be attributed to builders getting more creative with product offerings by value engineering homes on smaller lot sizes. Further, we are likely to see some discounting in Northwestern submarkets, near The Woodlands, due to oversupply in anticipation of corporate relocations that have not played out as planned.

Spring Selling Season Will Focus on Entry Level

In the face of affordability concerns, demand is holding up fairly well under $300,000. Further, it is expected that the upcoming spring selling season will be relatively strong at the first move-up and entry-level price points. We believe D.R. Horton is positioned well given their strategy to have spec inventory on the ground along with the success of their Express product, which has an average selling price nationally of $191,000.

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

Our price targets are based on a blended valuation methodology using an average of 10x our 2017 EPS est. and 1.5x our forecast 2017 book values. The stocks currently trade at 8.6x our 2017 EPS est. and 1.1x our 2017 BV est. Our top picks in the group are DHI and PHM. Other Buy-rated stocks include BZH and TOL.

Summary of Conditions

As 2016 and the spring selling season rapidly approach, we hosted a call with Scott Davis of Metrostudy to get an on the ground perspective of Houston given the ever changing landscape of this important housing market. Although slower growth is expected in the quarters ahead, we maintain our view that performance will continue to differ by local geography and price point. This reflects several underlying factors, as we describe more fully below:

- Job growth has slowed to about 30,000 annually (Dallas Fed estimated ~10,000) from ~100,000 last year. Many believe that Houston will end up adding 10,000-15,000 jobs this year and 20,000-25,000 next year. From a construction labor perspective, many of the large public builders here, including D.R. Horton, Lennar and KB Home, have been better at attracting labor to job sites given the larger scope and more consistent nature of their businesses. These companies should see greater relief on the cost side relative to smaller private builders as this labor shortage eases.

- For the four quarters ending 3Q15, single family starts in this market were down 4%. The question is where is Houston in the real estate cycle? Our expert believes conditions will remain subdued through the first half of 2017 before realizing faster growth. Specifically, he believes we will end 2015 at 27,500 starts (down ~10% year over year) and looks for 27,000 starts in 2016. Further, pricing is likely to pullback due primarily to product mix, though some discounting is expected in select submarkets.

- Double digit price appreciation over the past few years has caused affordability to be a headwind. We'd note the median new home sells for $276,000 compared to $211,000 for existing homes. That said, even with limited supply, the level of appreciation has moderated back toward the mid-single digit range, in line with historical norms. Some of this can be attributed to builders getting more creative with product offerings by value engineering homes on smaller lot sizes. Further, we are likely to see some discounting in Northwestern submarkets, near The Woodlands, due to oversupply in anticipation of corporate relocations that have not played out as planned.

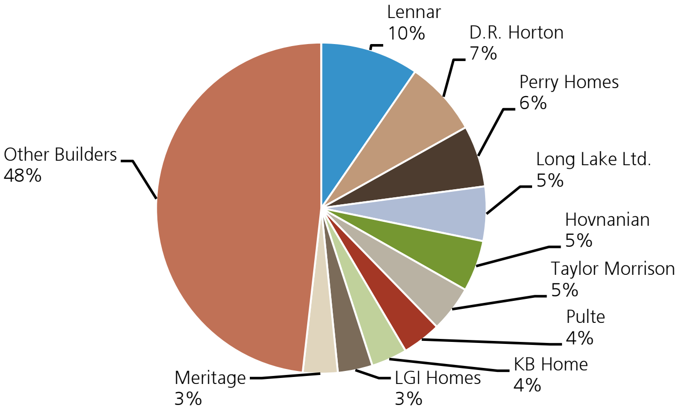
- In the face of affordability concerns, demand is holding up fairly well under $300,000. Further, it is expected that the upcoming spring selling season will be relatively strong at the first move-up and entry-level price points. We believe D.R. Horton is positioned well given their strategy to have spec inventory on the ground along with the success of their Express product, which has an average selling price nationally of $191,000.

Builder Presence: Operating Stats

Houston

With approximately 26,300 new homes closed in 2014 (based on data collected by Metrostudy and reported as part of Builder Magazine's "Local Leaders" series), the Houston/The Woodlands/Sugar Land metropolitan area ranked as the top housing market in the country. In terms of market share held by the builders, this area 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 52% in Houston.

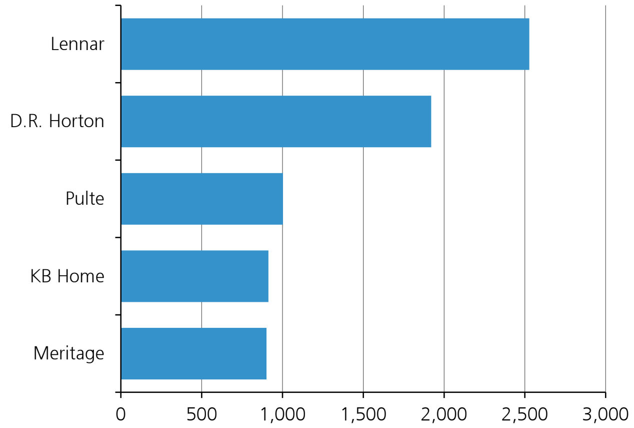
Figure 1: Share of 2014 Houston Closings, by Builder



Source: Builder Magazine (Metrostudy) and UBS

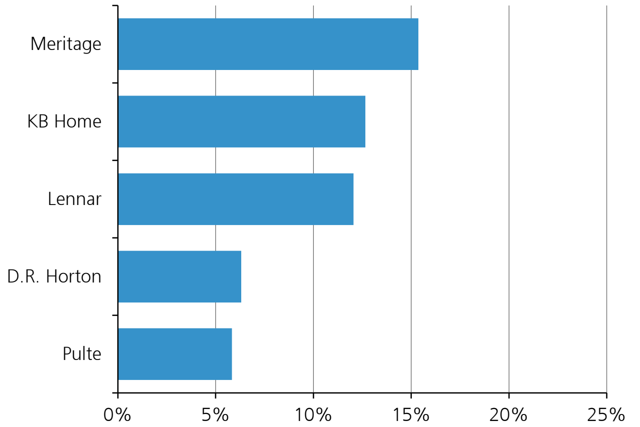
Within our coverage universe, Lennar closed the most homes in the area in 2014. However, relative to total company closings, Houston is more important for Meritage. Further, this market accounted for ~10%, ~10% and ~8.5% of 2014 homebuilding revenues for Lennar, Beazer and KB Home, respectively

Figure 2: 2014 Houston Area Closings



Source: Builder Magazine (Metrostudy) and UBS

Figure 3: 2014 Houston Share of Total Company Closings



Note: Calendar year Houston 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), company reports and UBS

Conference Call Transcript

Below, we present the transcript from our call with Scott Davis 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 today. We're going to get an update on the Houston market, which is certainly an area of the country that has been a big focus throughout 2015 and remains so especially as we look to next year.

With us today is Scott Davis, from Metrostudy, who will provide an overview of what's been going on there and some thoughts on his outlook. With that Scott, I'll turn it over to you.

Scott Davis: Great, thank you Susan. I appreciate the opportunity to speak to everyone. I want to cover economic and housing conditions in Houston and then we can open up for questions at the end.

Starting out, everybody has been watching oil prices. West Texas Intermediate crude is just under $36 a barrel as of this morning. When we started the quarter we were hovering somewhere around $40-45 and in response to that we have seen a fairly significant decline in jobs in the energy industry. The Texas Workforce Commission shows that as of October, we had about 33,000 net jobs added year over year. The Federal Reserve Bank of Dallas's number is significantly lower, closer to about 10,000. We tend to believe the Fed numbers are a bit more accurate.

The Workforce Commission shows that we've lost about 3,300 jobs in the energy sector. If you look at the other numbers, both the Dallas Federal Reserve and from the quarterly Census of employment and wages, they're pointing to closer to about 10,000 jobs being lost in energy. If those numbers are accurate, that would reflect about a 10% contraction in our energy production sector jobs. In manufacturing, we're down somewhere between 15,000-16,000. That's resulted in our starts down about 11% through the end of the third quarter on a year-over-year basis. Most of the forecasts that we hear for job growth are around 10,000-15,000 jobs in Houston this year and then about 20,000-25,000 jobs next year.

In a recent presentation by the Greater Houston Partnership, their chief economist estimated that we're about halfway through the job losses in energy and manufacturing. That would forecast about another 10,000 energy positions lost and about another 15,000 in manufacturing that will be gone before we see things start to turn up. The leading sector for next year is likely to be education and health services, which in Texas includes the medical industry. There are about 175,000 employees at the Texas Medical Center, which is almost equivalent to the Central Business District in terms of employment. Those institutions generate about $9 billion of revenue from outside of the Houston market. That's about 51% of their total, so they are an economic driver for the city. **Another area where we see increases are in construction. We do have $50 billion of petrochemical plants under construction in Houston area. Houston represents about 42% of the U.S. petrochemical manufacturing and refining capacity.** The challenge with petrochemical or downstream energy jobs is that there are significantly fewer than you might expect for that level of investment and they pay a lot less. The average upstream energy job in Houston has a salary of $202,000 compared with about $68,000 in the petrochemicals.

Turning to the housing markets, the apartment market has remained relatively strong. Last year we delivered 18,500 units and we absorbed 16,500 units on 107,000 jobs added. We did not see a dip in occupancy at all even with that oversupply because we demolished about 5,000 units that are now either townhomes or mid-rise units now coming to market. Our occupancy has held steady at about 91%. In the last quarter we fell from 91.4% to 91.0%. Why has that market remained so healthy? 400,000 of our 600,000 units are Class B and Class C. For the last 18 months our Class B and C units have been pushing 95% occupancy, which means that 2/3 of the rental housing stock in Houston has been functionally full and that really has explained the resilience in that market.

This year with only about 10,000 jobs added, we have absorbed 13,500 units. Again, it continues to be very strong but we will see challenges in that space next year. We've delivered 16,600 units to date. We've got about another 5,600 we expect to be completed by the year end count. Next year we have another 20,000 units under construction for delivery. That does not include anything that's been proposed. Those are all apartments that are under construction. So even though we've had an exceptionally strong year with 13,500 units absorbed on about 10,000 jobs added, we do expect to see some challenges with occupancy in that market. We believe it will decline to around 89% by midyear and then hover back to our traditional range of 87-88% by year end. About 8,000 of those units next year will be delivered inside the loop and another 8,000 will be in our suburbs, with roughly about 4,000 specifically in the energy corridor. By the end of next year, in limited locations, we should start to see some competition for an economic buy versus rent decision favoring apartment rentals. This is particularly the case in the Woodlands and the Katy area. Those are suburban areas outside of the energy corridor with the most significant forecasted increase in units. Even at today's housing prices in Houston, we still see it favoring buying homes with the exception of Class B three-bedroom units. That said, you'll have a tough time finding one as they have an occupancy rate over 95%.

We're starting to see the first cracks in the single-family market. Our closings have fallen slightly in the last couple of months but we've still been running over 80,000 closings a year on a rolling 12-month basis in the MLS for two years. We're seeing more strength in the existing market than we'd expect because we've primarily been diverting buyers out of the new home and into the existing home market.

We have seen our inventories start to build from 17,000 listings a month to 24,000. That's because of an increase in listings not a reduction in our closings. **We've seen our pricing come down and there's been some press about declining prices in the existing home market in Houston, but that represents a return back to our historical norm.** Our average price increase since 2000 has been about 5% a year. We're back to that level after being at double-digit price increases. Our supply is about 3.5 months with equilibrium between 5-6 months. We do see somewhat of a slowdown in that market appearing to start. It still remains relatively healthy by historical norms.

From a permit-issuing basis, Dallas has jumped ahead of Houston as the #1 market for increase in permits with about 5,700 through the end of the 3rd quarter. Houston was only up by about 1,000. On a permit issuance basis, Houston still issued 40% more permits than the Dallas market. **We do expect to see a slowdown but not anything of the short that would cause Dallas to surpass the Houston market in terms of its permitting of single-family**

development. In fact, if we took the top 15 builders in Houston by themselves, they would rival Atlanta in terms of construction. That would make those top 15 builders the 2nd or 3rd largest MSA by themselves.

In terms of our starts and closings, we had 28,608 starts and 28,403 closings through the end of the 3rd quarter. Our closings have held flat for over a year. That is partially because of delays in constructions due to weather. We're at 67 inches of rain year-to-date in Houston compared to about 49 inches for an average year. It is also because the backlogs for builders have been very strong throughout 2015 and they've been working through those. **As we look forward at backlogs going ahead, builders with an average selling price under $300,000 report similar backlogs. Builders with an average price over $300,000 seem to be split roughly half and half in terms of who's got a significant backlog and who doesn't.**

Looking at our new home inventory supply, we're at right about 7.2 months. It's been flat for about a year. We had about a 0.1 month pickup in the last quarter but we've been hovering between 7.1-7.2 since the 3rd quarter of 2014. That uptick was based on our increase in finished vacant inventory. Our under-construction inventory actually fell. Where do we compare regionally? Dallas is roughly 7.1, Austin's roughly 7, San Antonio is 6.6. Among the 45 markets where Metrostudy actively surveys lot and housing developments, the average is 9.3 months. We do remain well in line with the rest of the region and additionally in pretty good shape relative to most of the national markets. We've got about 4,600 finished vacant homes on the ground. We think that the market can absorb another 600-700 vacant homes before we reach a threshold point for supply in the market. For comparison that's roughly equivalent to the entire inventory of D.R. Horton added to the market before we reach that threshold point.

Geographically within Houston where are our strongest markets? The Northeast market remains very strong at under 6 months' supply. This is followed by the Southwest, West-Northwest and West-Southwest markets, which are all at about 6.7 months' supply. If you think of Houston as a clock with I-45 at noon, we're roughly talking about between about 7 and 10 on the clock in terms of geographic direction. Those are our traditional growth markets. We believe because of product offerings in those markets that they will continue to perform even in a slowdown.

In terms of our housing inventory by price range, our under-$200,000 inventory has almost completely gone away. Two of our leaders in that segment, Long Lake and LGI had average sales prices pushing $190,000 in the 3rd quarter. Our inventory above $500,000 has increased slightly, but has remained pretty steady since about the 1st quarter of 2014. Where we're seeing real growth is our inventory between $300,000-400,000, coming primarily from being very near the conforming loan limits. Additionally, when we look at recently-built homes sold in the MLS, the average sales price there is $325,000 indicating our fiercest competition is from the existing sales market.

In terms of our top master planned communities, River Stone by Johnson Development has remained #1 and Aliana Development is #2. These are followed by Canyon Gate West, Woodforest and Cross Creek Ranch. The Woodlands has fallen to #8 with only about 320 starts. Cinco Ranch is down to 254 at #15, almost completely falling off the list. When we look at the top 25 master planned communities in Houston, roughly 40% of them have two years or less of lot supply left at current closing rates indicating the need to refresh that list. The other thing

that we have seen is that historically master planned communities have about a 35% market share in Houston. However, in times of economic downturns such as 2002, 2003, 2010 and 2011, master planned community share rose to 55% of the market. During times of economic weakness we'll see a flight to quality both geographically and in product type. So we would expect our master planned communities to see their share grow and either retain the current pace of closings which they presently have or perhaps even increase the share of closings that they have during the next 18 months. This indicates the importance of continuing to refresh that supply of master planned community lots.

D.R. Horton overtook Lennar as the #1 builder in the market in the last four quarters with 2,500 starts. This compares to about 2,450 for Lennar. D.R. Horton has 608 units of finished vacant inventory, which represents roughly 15% of the total in the market. A lot of that is in the Express product, which is priced between $179,000-209,000. We are watching that because at their current rates of closings, they are at or above equilibrium for finished vacant inventory.

Lennar, Perry and Taylor Morrison are the #2, #3 and #4 builders, respectively. They have also had fairly significant inventories but those builders together have less inventory than D.R. Horton and all of those are at or below market levels of equilibrium. Long Lake comes in at #5 with about 100 units of inventory off of 1,363 starts. We see Hovnanian, LGI and Long Lake falling down the list. The most dramatic is LGI who was at #6 a year ago and is now down to #10 with 847 starts. Those builders are really struggling to supply entry-level product below $200,000 and we think given pricing in our market, they'll continue to do so.

We were at 28,608 starts and 31,172 in terms of our lot deliveries, the most we've had in a quarter since 2008. This came on the strength of having about 8 weeks without rain in July and August. The governor on our supply today still remains our inability to develop lots. A decade ago we were delivering 50,000-55,000 lots a year. In terms of our supply, we're at 16.6 months, which is still below the equilibrium level of 20 months. That said, we are starting to see the market behave as if we have reached equilibrium in some ways.

We're seeing our price increases slow in every parcel size except our 80-foot lots. The price increases in the 3rd quarter of 2015 were lower than at the 3rd quarter of previous years. Our 70-foot product fell, the average price increase in 2013 was $18,500. It's down to about $7,500 in this quarter. Our 60-foot lots have fallen from $7,500 price increases to about $3,500 price increases so again we're seeing the rate of expansion slow.

In terms of our future lot locations, the West-Northwest submarket—that's I-10 North along the route of the Grand Parkway up to 290—has 37,000 future lots. About 17,000 of those are in Howard Hughes' Bridgeland development. The Northeast has about 28,000 parcels, the far North has 19,555, West-Southwest has 17,097 and Northwest has 16,198. The effective future supply is roughly 16,000-20,000 lots in each of those submarkets. Our total future inventory came down by about 4,000 lots to 158,000. That's roughly #16 of the top 20 markets. Our method of accounting future land in Houston accounts for the relative ease of development in our market. Additionally, our months supply at about 55 remains #1 in the country.

When we look at pricing, we see in the Northeast market our median price is around $240,000, but 50% of the product is within about $50,000 of the median price. The Northeast market has been very successful targeting a very narrow

segment of consumers. When we look to the Southwest, West-Southwest and West-Northwest markets, we have median prices between $350,000-400,000. This is significantly higher than the Northeast market, but 50% of the product is within $150,000 of the median price and we have homes across all pricing segments so we think those areas will maintain their traditional development edge over the rest of the city because they have the ability to target several consumer segments.

As we look at the conditions in the Houston market today, we see a drop-off of about 1,500 units on a year-over-year basis. This looks like a lot of the seasonal movements that we saw in 2010, 2004 and even back into the '90s. When we control for seasonal effects and just look at the trend, we are clearly into a downturn in that space. That's confirmed by our pricing. In 2013 and 2014 we were averaging between 13-14% annual increases in price and we're down to about 7%. It appears as though we have reached the peak in the market.

Where are we in the cycle? **The recovery phase in Houston's single-family real estate market began in the 1st quarter of 2011. We entered the expansion phase in the 4th quarter of 2012 and then we peaked in the 4th quarter of 2014. We're in phase 3 or the hyper-supply phase if you're familiar with the real estate cycle. So the question is what happens in that phase? How long will we stay there? We looked at the same metrics in the last cycle in Houston. Our high-supply phase began in the 4th quarter of 2001 and ran for almost 6 years until the 1st quarter of 2007. In that period of time we doubled the number of starts and closings in our market.**

Although we're not recommending that as a strategy this time because it didn't work-out so well, we wanted to demonstrate that we can exist in this cycle for a long time and we can build even more houses than we did the year before in this period. We think that we are almost 12 months into a 3-year phase in the back half of the cycle. We would expect to enter the recession phase about mid-2016. We think we will then emerge mid-2017. Because our peak in this cycle was relatively short, we think that the downward trough will be relatively light as well.

What are the strategies that we are recommending? First is not to panic. We will still build and sell a lot of houses roughly 12 months into this 3-year phase of the cycle. Watch the flight to quality and look for what's been quality. That has been the Southwest, Northwest, Northeast and the Central market has also been very strong. For builders, we recommend to get ugly early in discounting as necessary to avoid long inventories. Don't try and catch the falling knife as we see prices pull back a little bit. Negotiate tough on lot pricing. We really need our landowners to get the message of where we are in this cycle.

We recommend that builders economize on plans and offerings. If you have 25 plans, maybe you can more economically offer 15 plans to save on those costs. Watch the waste stream and staffing. We recommend making sure that you're putting the right product in the ground at the right place at the right time. We have just introduced a new product here in Houston called our land portfolio optimization where they use our product to determine what is the best demand and when is the best opportunity to put product down. Whether you get it from us or somewhere else, make sure that that's part of every deal that you look at so you can avoid overbuilding your inventory.

For developers we recommend securing future lot commitments as quickly as possible. Particularly for investors and developers, we think it's important to

accumulate dry powder to deploy in the down cycle and then start evaluating opportunistic investments for phase 4 of that cycle, which we think will start in about mid-2016. As of September 2015, there was $244 billion parked in closed-end private real estate investment funds, so the money is there. We know there already have been some deals that are on the market and have been traded, but those have been overpriced or lower-quality in secondary locations. We think there will be opportunities beginning mid-year. We've started having conversations with a couple of our stronger builders who are looking.

What are the flies in the ointment? What are the challenges that we expect to see? The first is interest rate risk. I think it's a foregone conclusion that we'll see the Federal Reserve raise rates later this month. I think that's already priced-in. We've been at about 4.25% for the 30-year rate, although I've seen it has pulled back in the last three or four days. At 4.25% for a 30-year fixed mortgage, you are looking at only 38% of households in Houston being able to afford a median-priced new home. If rates go up 100 basis points, that drops to 36%. If rates go up 200 basis points, only 34% can afford a new home. Every 25 basis point increase in mortgage rates prices 13,000 households out of the new market and 13,500 households out of the existing market in Houston. What is the difference on the median price of a new home for a quarter-point increase? It's about $55 a month. We're talking about taking your kids to the movies or the family out to dinner once a month being the difference between someone being able to afford a home in our market with each of those increases in rates.

The other challenge is just plain old affordability. We use this statistic called the median multiple to measure affordability. That's the median home price divided by the median household income. Three is the multiple that we would consider affordable. That's the point at which a family is spending roughly 30% of their income on housing. In the 3rd quarter of this year the median new home price is $276,000. The median household income was about $70,000. That yields a median multiple of 3.92. For those of you in some of the more coastal markets, that might still seem affordable. Many of our coastal cities are at 5 or 6 in terms of multiples. When we look at the existing home market, we see a price of about $211,000 and when we divide by $70,000 that yields a median multiple of 2.82. We've got almost a 120 basis point spread between the relative affordability of existing versus new homes. From 2005-2012, the spread between those was about 50 basis points. In the last three years that's doubled from 60 to almost 120 basis points. **The real challenge here in this market and why we're seeing a slowdown has less to do with oil and more to do with the increase in pricing and relative affordability in Houston as 3.92 is the highest that our median multiple has been in over a decade.**

As we move into next year, we'll see more of the recently-built product enter the existing home market. That will probably pull our existing home price up slightly raising that median multiple. We also will see a little bit of a pullback in those median new prices, not as much from price declines but more from a change in the product mix as developers and builders are rushing to put more 50 and even some 45-foot product on the market. Those changes won't be enough to narrow that gap by more than about a third in the next year so that will make new homes more attractive to a buyer but it won't address the issue of affordability market-wide.

You can see it reflected in our cost of living. 10 years ago the cost of living index in Houston was 90 compared to 106 today. The U.S. average is 100. It still relatively

affordable but that represents a 20% increase in the cost of living in Houston in the last 10 years.

We are seeing a little bit of that slowdown, down about 10%. **I think that's likely where we will end-up at about 27,500 starts for the year. We are looking at about 27,000 starts likely for next year.** We probably will see pricing pullback next year. Some of that as a result of price declines in the market but most of that largely from a change in our product mix as we try and offer more lower-end, entry-level and first move up type housing.

Beyond that, our population growth does not seem to have generally been affected. Every year for the last five years we've averaged about 140,000- 150,000 increase in population. Greater Houston Partnership is estimating this year we went down to about 125,000. It has not declined significantly based on what you'd expect in economic changes.

To sum-up, I think we're going to see a tough end to 2015 for some of our builders and some rough times in the 1st and 2nd quarter as some of those divisional layoffs are announced. We should see it smooth out in the second half of the year. One of the important things to remember is that our current inventory levels don't dictate a slowdown. We are actually at lower inventory levels in terms of finished vacant housing on the ground and vacant developed lots than we were at the beginning of 2013 when we saw 13-14% price increases. We should see a resumption in the level of activity when we see some additional economic growth. With that Susan, we can open it up for any questions.

Susan Maklari: One thing that we've heard a lot about in this market is the issue around labor and it seems to have been exacerbated given all that rain that you've seen. Can you talk a little bit about what's going on from that perspective? Has anything changed and should we expect anything different in 2016?

Scott Davis: Great question. Labor continues to be an issue. The reports from our builders are that most of the problems have gone away in terms of unskilled labor. We have an adequate supply of those people. However, it remains fairly tight in terms of skilled labor such as framers and finish carpenters. We are starting to see some increasing availability of labor as you go up the skill ladder. Our builders have told us they're now starting to hear from painters and some of the carpenters that are calling back around to look for additional work and are trying to get tied-in. They are going to the most active builders first such as D.R. Horton, Lennar and KB Home. Those groups will see a bigger relief from labor costs than the second tier or larger private builders simply because they can guarantee a greater stream of work.

I think we will see it change a little bit but not as much as people would like. We're also seeing material costs starting to come down. The one exception is concrete. It has slowed but our annual concrete price increases are now about 10% instead of 25%. Although they have come back, they're still fairly high. I have a feeling in talking with our groups and in the research that we've done that a lot of that labor is still being attracted to the Dallas market. I know you had a call on Dallas, so I would defer to my counterpart there on exactly what's going on, but part of what we've heard is that they're still very competitive for labor and that could be what is attracting some of that labor out of Houston or at least out of the oil patch.

Susan Maklari: You mentioned that some advice you're giving to builders is to start discounting early to clear some of the inventory that is on the ground. Can you give us a little bit more detail around that? What level of intensives or discounts are you seeing or expecting? It sounds like inventory is relatively tight, so will it be very concentrated?

Scott Davis: Inventory is fairly concentrated. The biggest areas of inventory right now are in the Central and the far North markets. Inside the beltway and the bulk of the Central market development is inside the loop, so we're talking about urban product. The other area with the most significant inventory is the North market, which includes The Woodlands. We're not as worried about inventory in the Central market because that is a higher-end area. It would take a little bit longer to trade and we haven't seen much in terms of weakness in that product, which trades at roughly $900,000-$2 million.

We've seen a lot of supply come into the far North market. One of the big drivers of growth in that area was anticipating the corporate relocation of Exxon. As we understand it, much of the Exxon employment is there. We confirmed our first sale of a single-family production home to an Exxon employee who has relocated to the Houston market this quarter. We have not seen the benefit of that group moving in and that's one of the big reasons that we're seeing weakness in that far North section. We would expect to see discounts there. From what I've heard, it will probably be somewhere in the area of 5-10% in order to try to get that housing moved. They've also struggled due to the construction of the Grand Parkway.

One of the other areas of concern is if you're adjacent to one of the top 5 homebuilders, particularly near D.R. Horton because of the amount of inventory they have. D.R. Horton has a very sizable development in the West-Southwest market, which has done fairly well, up 300 units this year in its first year of sales. That is one area that we're watching. The other location where Horton has a lot of inventory is in the far North market, just south of the Woodlands. That's an area which has really lagged because of the Exxon development and not bringing those large numbers of relocations into the single-family market. The other is because construction of the Grand Parkway has complicated access to those developments. That Grand Parkway should be complete in the 2nd quarter of 2016. I think some of those areas will see an improvement as a result of that.

Susan Maklari: With all the moving pieces that are going on in this market, how are the builders thinking about the spring selling season? We talked to your counterpart in Dallas 2 weeks ago and she was saying how builders are trying to start more specs going into the spring given the dynamics going on there. What are you seeing in Houston and how are you thinking about builders positioning themselves for selling season?

Scott Davis: If you're a builder with an average sales price under $300,000, you probably are starting specs to have those available for the spring selling season. What happened in this cycle is that we really value engineered, particularly our 50-foot product. We saw prices rise in that segment from about $250,000 to $325,000 for a 50-foot product. The reason that we did that is it was so difficult to get people below that price point qualified. We really went after that segment. That priced a huge pool of buyers out of that market and now we're seeing developers supply more lower-end lots. We're also seeing builders start to take a look at the 40 and 45-foot product. I even think KB Home has got a 35-foot

product they're looking at in the market. They're also looking at de-featuring, for lack of a better word, that 50-foot product to get that back into that price range.

Above $300,000-350,000, we're seeing a little bit more softness, particularly in the spec market. Most of our builders in that area have told us that the to-be-built market—somebody coming-in and saying I want a house with these features—has remained relatively steady and that the spec buyer has largely gone away at that price point. What that suggests to us is that today in Houston, if somebody wants to buy a house, they're going to go buy it.

Across most of the categories, the most active builders are still looking at opportunities but most of them have expressed a few beliefs about it. **One is that it's going to be a first move up or maybe even an entry-level buying season in the spring. They're going to watch it very closely for opportunities because they think that if you wait for confirmation of the numbers, you likely will miss it because it's going to be a short cycle.** In terms of the spring selling season, we think it'll be active below $300,000-350,000. Once they get through that they'll be looking at buying new lot opportunities.

Susan Maklari: Taking all of this into consideration, how do you think about the level of starts for next year for this market? Does Houston stay on top or does Dallas or one of the other markets overtake you?

Scott Davis: We think about that a lot. I would be surprised to see the Dallas market overtake us. When we look at our sales and traffic numbers through our surveys, we show that our traffic is up about 3.5% year to date through the end of October. Our cancellation rate has gone up a little bit but we're still generating a fair amount of traffic out to these communities. Our starts are down about 10%. Our closings have been flat. **I think that we'll hold that 10% number into the end of this year and that we'll see it go down a little bit next year.** I don't think we've got another 10% decline in there. I think at most we would probably see about another 5% decline because of the job losses we've seen.

We have largely absorbed the headline risk plus the first half of the job loss risk. What we're looking at is really just the second half of the job loss risk for next year. I think those headline numbers for Dallas job growth are overstated. If you look at the delta between the Federal Reserve numbers and Texas Workforce Commission numbers, TWC shows Dallas pushing 90,000 jobs year-to-date and the Fed is closer to 60,000-65,000. I think that's probably where they'll end up and that we won't see as much growth in that market as you may think. I think it's unlikely you'll see Dallas overtake us given the supply challenges there.

The last cycle before the financial crisis, we saw the highly-regulated land use markets experience double-digit price increases because the local environments artificially constrained the lot supply. In this cycle we're seeing double-digit price increases across all of the lightly-regulated land use markets including Houston, Austin, Dallas, Denver and the Carolinas. The reason we're seeing that is the conditions that lead a local economy to lightly regulate land use are also the conditions that foster growth. All of those markets are growing. Where the constraint in lot supply is today is the lack of debt that's available. Federal banking regulations in terms of not having money out there to loan on acquisition and development deals for real estate is constraining the lot supply and in each of these markets we're seeing that.

The same spread between new and existing in terms of affordability exists in all those markets and that's going to serve as a cap on the growth that we're going to see in those other areas. Even if we pull back a little bit in Houston, I would be surprised to see any of the other markets overtake us. I think Houston should hold onto that #1 position. We will see it come down a little bit, just representing more of that return to more normal market conditions in Houston and presenting some investment opportunities.

Energy is not going to go away. Oil and gas are not going to go away anytime soon. That remains a prime mover of the Houston economy. Yes, we see oversupply situations but we also see that Venezuela's run out of cash and it's liquidating their gold reserves to pay debt. Saudi Arabia is now issuing government bonds for the first time in over a decade. You look at the crisis in Russia. This is not a supply condition that we can see go on forever and we would expect to see that reversed eventually. I think for all those reasons, we're going to see a downturn in Houston but it should be relatively short and not significant enough to cause another market to surpass us.

Susan Maklari: One trend that we're starting to hear about in certain areas is that some people are preferring to stay in their homes and perhaps take on more remodel work in their current residence rather than going out and buying a new home. Are you seeing that at all in Houston?

Scott Davis: I haven't seen an uptick in that type of remodeling activity yet. I would expect to see that in some of the other markets that have seen similar price increases to Houston, but started at a higher price point. We're seeing people looking at the existing housing market with plans to remodel. The other thing that we're seeing is related to the active adult segment. I think we're undersupplied in terms of that product. Everybody has been chasing the millennials because that's the next big thing. They're trying to figure out how to get them to buy houses. A number of our builders have started to develop product that's targeted towards millennials. It might be a patio home, a townhome or zero lot line product. However, we're actually seeing boomers come in to buy those and then spend $30,000-40,000 to upgrade the builder grade finishes to have a more luxury lifestyle. I think we will see more of that remodeling activity moving forward, but we're even seeing it in the new home market to some degree as people try and fit the product that's available into their lifestyles.

Susan Maklari: Can you tell us about what you're seeing from the smaller private builders? Are you seeing any increase in stress there? As we get into this slowdown, how do you think about the impact to them?

Scott Davis: Great question. There have only been one or two builders I've heard of with any kind of stress. Those are at the very high end of the market with an average sales price between $450,000-500,000. Most of the rest stand to benefit because our smaller private builders, outside of one or two, don't really develop lots. We've seen about a 10-15% pullback in lot prices offered by developers so they have been able to come in and pick up lots at a reduced cost basis over where they were say a year ago. Some of them have been very strategic and opportunistic in terms of taking this opportunity.

I think about Highlands out in Dallas in particular as one. They've introduced their Horizon product into our market, which is an entry-level type product. Highlands is a mid to high-level private builder here and now they've come in with a 45-foot product and have experienced a lot of success. I think some of the private builders

are able to respond more quickly than some of the publics. They don't have quite the competition for capital from other markets that the public builders have. Their management is probably a little bit less reactionary than some of the public companies. That said, some of our publics have responded very well to the changes here in the market

I think the private builders for the most part will do very well. I don't see anybody in this group that is a candidate for selling out of the market or bankruptcy. No one has overextended in the way that certain builders were in the last cycle. Oddly enough, the private builders may fare pretty well because they're going to be able to reduce their lot costs and that's been a real challenge for them. They haven't had control of that supply and have been dependent on some of the larger publics that do development.

Susan Maklari: Scott, I think with that we will wrap it up. Thank you for the very thorough overview and it'll certainly be interesting to see what happens here next year.

Scott Davis: Absolutely, it's always interesting. The thing I'd keep in mind about next year is that there are going to be real opportunities in our market. Keep an eye out for those. Beyond that I wish everybody a happy holidays and happy New Year. I look forward to speaking with you all next quarter.

Susan Maklari: Thank you to everyone that has dialed-in.

Statement of Risk

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.

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Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
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Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2015.
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.
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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Beazer Homes[16]	BZH.N	Buy	N/A	US$11.66	21 Dec 2015
CalAtlantic Group Inc[16]	CAA.N	Neutral	N/A	US$37.13	21 Dec 2015
D.R. Horton Inc.[16]	DHI.N	Buy	N/A	US$31.41	21 Dec 2015
KB Home[16]	KBH.N	Neutral	N/A	US$12.25	21 Dec 2015
Lennar[4, 6, 7, 16]	LEN.N	Neutral	N/A	US$48.05	21 Dec 2015
Meritage Corporation[16]	MTH.N	Sell	N/A	US$33.42	21 Dec 2015
PulteGroup, Inc.[16]	PHM.N	Buy	N/A	US$17.77	21 Dec 2015
Toll Brothers[16]	TOL.N	Buy	N/A	US$33.35	21 Dec 2015

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