

# U.S. Homebuilding

## Phoenix Call Transcript: Demand Persists Despite Limited Supply

### Equities

Americas  
Home Construction

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### Update on Phoenix Housing Market

To get real time updates on conditions, we host calls with local experts across the country. We recently spoke with David Brown, Senior Vice President of the West region for Metrostudy. The Phoenix market has experienced significant volatility in the recovery, yet it appears to be stabilizing. This area has seen good job growth, which is expected to continue, as well as a significant pickup in starts from the prior year off of an easy comparison. That said, labor constraints in the construction industry and limited supply remain areas of focus that could limit the magnitude of growth this year. Given this, our expert expects starts to increase 10% in 2016 to ~20,000.

### Builders Shifting More Focus on Affordable Product

Over the past few years, builders have focused primarily on move up price points given the increasing cost of land. That said, there has been a gradual improvement in demand from entry level and first time buyers. As a result of this and competition faced from the existing home market—where median prices are ~\$95,000 less than new homes—builders have been slowly expanding production to the next submarkets outside the core. It is here where land prices are lower and builders can produce more affordable product to target this demand. In Phoenix, D.R. Horton and LGI Homes have been leaders on this front, while others are expected to follow.

### Limited Supply in Most Active Areas

Another factor that's playing a role in expanding activity to the periphery is that supply remains limited in core submarkets, including both finished vacant inventory and lots. Finished vacant inventory stands at just 1.8 months, which is the lowest level since 2013 and down 30% year over year. This indicates builders are having difficulty keeping up with demand. From a land perspective, while Phoenix ended 2015 with 52,000 parcels, it has just 15,000 in the most active areas (where ~75% of activity occurs). This represents 17 months of supply, below equilibrium of 25 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 1.1x our 2017E BVs. Our top picks in the group are TOL, LEN and PHM. We also highlight Buy-rated BZH.

## 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 increased. 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 homes growth of ~10% for 2016.

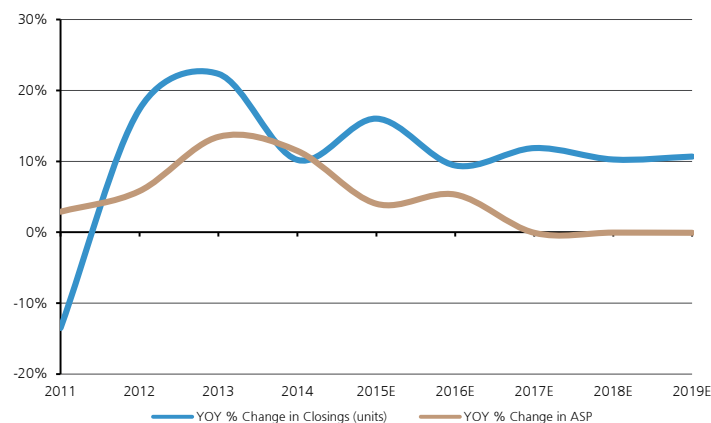
### UBS VIEW

**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.

#### **Volume Growth vs. Home Price Appreciation**



Source: Company reports and UBS estimates

## Summary of Conditions

The Phoenix market has experienced significant volatility in the recovery, yet it appears to be stabilizing. This area has seen good job growth, which is expected to continue, as well as a significant pickup in starts from the prior year off of an easy comparison. That said, labor constraints in the construction industry and limited supply remain areas of focus that could limit the magnitude of growth in 2016. We provide additional detail below:

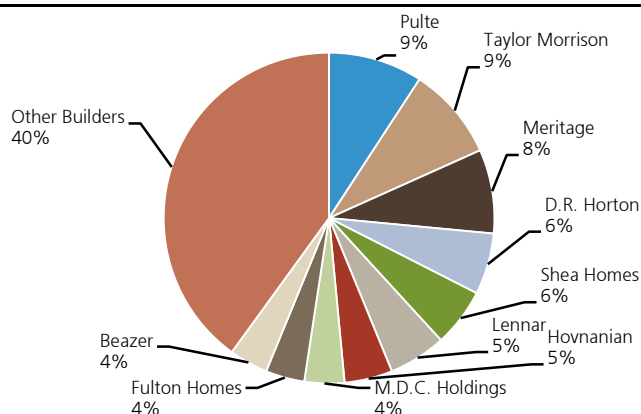
- Employment growth in Phoenix remains healthy, adding 55,000 net new jobs in 2015 (+2.9% year over year). This growth was spread across all sectors, with professional & business services and education & health services experiencing the greatest increases. We'd note, the construction sector added ~7,300 jobs (+8% year over year). Although this is a positive given the labor constraints felt by builders nationally, it is unlikely to be enough to meaningfully ease the burden. Our expert believes we will see continued growth next year and anticipates 50,000-60,000 job additions.
- Over the past few years, builders have focused primarily on move up price points given the increasing cost of land. That said, there has been a gradual improvement in demand from entry level and first time buyers. As a result of this and competition faced from the existing home market—where median prices are ~\$95,000 less than new homes—builders have been slowly expanding production to the next submarkets outside the core. It is here where land prices are lower and builders can produce more affordable product to target this demand. In Phoenix, D.R. Horton and LGI Homes have been leaders on this front, while others are expected to follow.
- Another factor that's playing a role in expanding activity to the periphery is that supply remains limited in core submarkets, including both finished vacant inventory and lots. Finished vacant inventory stands at just 1.8 months, which is the lowest level since 2013 and down 30% year over year. This indicates builders are having difficulty keeping up with demand. From a land perspective, while Phoenix ended 2015 with 52,000 parcels, it has just 15,000 in the most active areas (where ~75% of activity occurs). This represents 17 months of supply, below equilibrium of 25 months.
- Our market expert, David Brown of Metrostudy, expects starts to increase 10% in 2016 to ~20,000. He noted that upside to this forecast seems limited given labor market constraints and limited lot supply.

# Builder Presence: Operating Stats

## Phoenix

With approximately 9,700 new homes closed in 2014 (based on data collected by Metrostudy and reported as part of Builder Magazine's "Local Leaders" series), the Phoenix/Mesa/Scottsdale metropolitan area ranked as the 6<sup>th</sup> largest housing market in the country. In terms of market share held by the top builders, this area is slightly more fragmented than other major markets. In each of the 50 largest housing markets in the US, the top 10 builders were responsible for approximately two-thirds of new home closings in 2014, which compares to 60% in Phoenix.

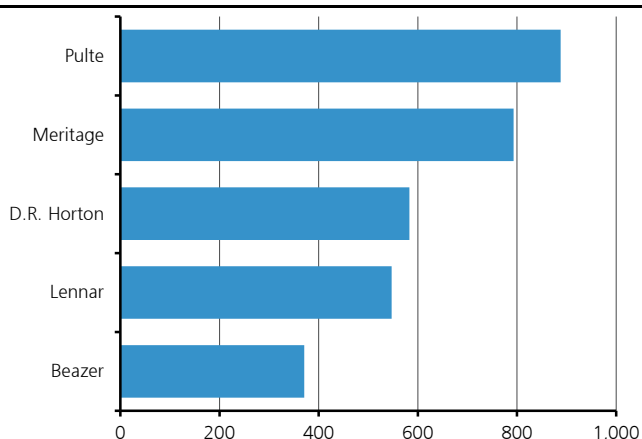
**Figure 1: Share of 2014 Phoenix Area Closings, by Builder**



Source: Builder Magazine (Metrostudy)

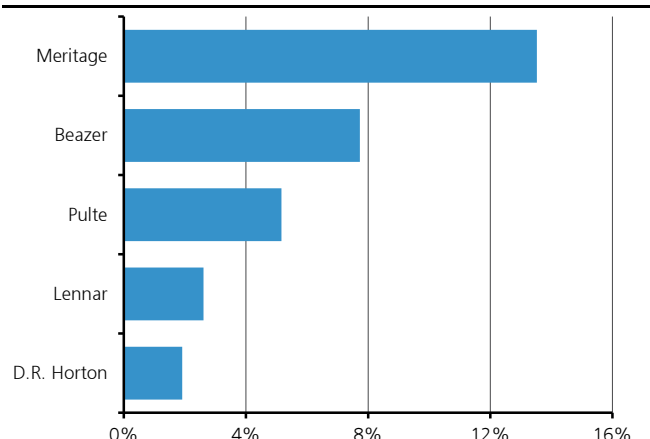
Within our coverage universe, Pulte closed the largest number of homes in the area in 2014. However, relative to total company closings, Phoenix is a more important market for Meritage.

**Figure 2: 2014 Phoenix Area Closings**



Source: Builder Magazine (Metrostudy)

**Figure 3: 2014 Phoenix 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 David Brown 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 be getting an update on the Phoenix market as the selling season gets underway. With us is David Brown from Metrostudy to give us an idea of how it's all coming together. With that, David I'll turn it over to you.

**David Brown:** Thank you Susan. I appreciate you having me on the call today.

I thought I would start off with giving some background on what the economic drivers look like in Phoenix, including where we were in 2015 and what our expectation is for 2016. I'll also cover the most recent trends in the housing market in terms of new and existing home sales as well as housing starts' activity. We also conduct a traffic and contracts survey in the Phoenix market so I'll address some of the latest trends that we've seen here in January and February. The last two pieces that I want to cover are housing supply and lot inventory. We'll dig down and get a sense of the future development pipeline in Phoenix. So many times we focus on the demand side without looking at the supply side of the picture.

Looking at job growth in Phoenix, 2015 was a very good year. We had solid growth through the year, trending upward through the second half of the year after a very weak first half of 2014. The strengthening began in the second half of 2014 and continued through 2015. We ended the year with 55,000 jobs added, which is a 2.9% growth rate and above the national average. Phoenix ended up coming in as the #8 ranked MSA for job growth in the country.

When we look at jobs, one of the things that we look at is the risk that we could see a shift in the trends in the job growth. How widespread is the job growth? Is it concentrated in one or two sectors, or is it spread out amongst a number of sectors? The good news is in 2015, those 55,000 jobs were spread across all sectors except for one. Government was the only sector that experienced a loss, down 1,400 jobs. All the other sectors saw job growth. The areas that we saw the most growth were in professional business services, which was up 17,600 jobs, education and health services, which was up 8,800 jobs and construction, which was up 7,300 jobs. Those sectors reported the strongest growth but the expansion was spread across all of the other sectors too, which is indicative of much more sustainable growth into 2016.

**In terms of our outlook, we expect job growth to look very similar in 2016 as it looked like in 2015. We'll likely see somewhere in the 50,000-60,000 range of jobs being created during the year.** The unemployment rate stands at 4.7%. What that tells us is that employers are going to have to start competing for employees and they will begin to put pressure on wages. We'll also have to see employers attract some employees from outside the market. That creates demand for new apartments as well as homes. Both of those things point to continued healthy demand for housing. Wages should begin to grow at a faster pace than what they have in the past and that's good because we're seeing rents and home prices continue to grow.

I did want to talk a bit about the latest trends that we're seeing in home sales activity. We have the MLS data through February of 2016 and the annual sales

pace is up 10% year over year. We did see in February that activity beginning to flatten out. Sales were off about 2% for the month compared to the prior year. There are a couple of factors that come into play here. First off, existing inventory continues to fall. It's down 2% from a year ago with only 21,000 homes listed for sale. You also have to understand we're beginning to get into a period where we have less favorable year over year comparisons in terms of activity.

2013 was a phenomenal year for Phoenix. We saw job growth slow in the latter part of 2013 through the first half of 2014. Prices had jumped significantly in 2013 and both those factors choked off some of the demand and we saw sales drop. As we got into the second half of 2014, that began to improve some, but 2015 had very strong year over year comparisons. Now we're comparing it to the same very strong numbers that were occurring in the early part of 2015.

Getting back to supply, with sales up 10% year over year, inventory is continuing to decline. Between sales growing, inventory falling 2%, the monthly supply is down 11% year over year. This represents only 3.2 months' of supply. About six months is generally considered equilibrium. These very tight conditions are driving down the average days on market. The average number of days on the market right now is 83, compared to 94 a year ago. Those are the numbers from MLS and most of that's existing homes, but there are some new homes in there. We're also tracking deed closings. I went into our database and the deed records are reporting 14% growth in closings year over year.

Now on the new home side in terms of home building activity, we saw a tremendous surge in starts in 2015. We had 14,100 new homes started, that's single-family detached and town houses in the Phoenix Metro Area. That's a 45% increase over 2014, but understand that is making a comparison to a fairly weak 2014. I went back to 2013 to see what the change is from that year because 2013 was a pretty strong year for the market overall. 2015 still had 22% more starts in the year. Overall, Phoenix had tremendous growth in terms of activity.

Looking at closings—we gather our information by driving every street and every subdivision doing a full census of the inventory and the change in that to calculate what the starts and closings are. A closing for us is not necessarily a deed transferring and getting filed. It's us seeing somebody move into the house. It's an observed occupancy of that house. When we looked at closings in 2015, they grew 11%. That number could have been much higher, but one of the dynamics that constrained us this last year was labor constraints, which extended out the construction cycle. Some of the closings that builders thought they were going to get closed in 2015 got pushed into 2016. If you look at activity in 2015, the surge in starts really started in the second quarter, which was in response to some very strong net contracts in the first quarter of 2015. I'll talk about contracts and traffic here in just a minute. But the real surge and the drive in that 45% growth was in the last three quarters of the year.

**So as we get into 2016, what does that mean? Well in the first quarter, we're going to continue to have favorable year over year comparisons. We're out doing our field research right now for the first quarter. We generally do it in the last 2-3 weeks of the calendar quarter so we're just getting our survey started and we'll be doing that over the next couple of weeks in Phoenix. As we get into the second quarter, the growth rate should begin to moderate. For starts, we're forecasting healthy growth in the first quarter, but it's going to moderate into the second, third and fourth quarters. We think we'll end the year up about 10% for total starts in the market.**

Looking at price trends and what's happening in terms of pricing in the market, I'll start off again first looking at the MLS numbers. The medium price a home in the Multiple Listing Service in 2015 was \$222,000. That's up 9% from a year earlier. The medium price of a new home in 2015 using our deed records was relatively flat year over year at about \$295,000. That said, if you drill down into it, you'll see that on a price per-square-foot basis, the medium price per-square-foot grew 4.3%. That tells us that the mix changed a little bit in terms of the size of some of the homes that sold.

One of the other things that we do every quarter when we're doing our field research is to gather the product offerings from the builders. That allows us to make a quarter-to-quarter comparisons of every floor plan within the market to get a true paired comparable in terms of pricing. We can see what builders are doing—if they're raising prices, holding them steady, or in some cases pulling back if sales are not as strong. Typically there is a lot of seasonality in the price changes that builders make. We usually see the strongest in the spring and into the summer selling months. As we get into the fall and the winter, that slows down. The fourth quarter typically has the smallest price increase due to the seasonal sales cycle. When we look at these price changes, I always like to compare it to the same period from the prior year. If we look at the average price change that builders made in the fourth quarter of 2015, it was up about \$4,000 on average. That's up from the average increase that we saw in 2014, but in line with what we saw in 2013.

Our expectation is that we're going to see this mirror the trends of what we saw back in 2015 because of the trends that we're seeing in terms of the demand. You also have to drill down into that to get a better understanding of what's actually happening in the marketplace. If you read the Wall Street Journal yesterday, there was an article about this. One of the dynamics that we've been seeing over the last year or so in many of our markets across the country is this bifurcation where because builders have focused so strongly over the last several years in the move-up market, competition's getting higher. We're beginning to see in some markets the inventory rise but the competition's higher and therefore the ability to move prices in those move-up price points are less. But because of rising land and construction costs, the supply continues to shrink at the most affordable price points and so we're seeing the strongest pricing power.

The same trends are happening in Phoenix. In the fourth quarter, prices increased the fastest for homes priced under \$250,000. The annualized rate of increase in that under \$250,000 price point was about 3.6% overall. This compares to the move-up price points in Phoenix about \$350,000-650,000 that had the slowest rate of increase on average in the fourth quarter at an annualized rate of about 2.6%. So there was about a 1% difference between the low end and those move-up price points.

The other dynamic that's relevant is the gap between new and existing homes. The medium price listed in the MLS is about \$222,000, though that includes some new product. When we look at deed record transactions, the medium price of existing homes is just a little bit under \$200,000 compared to \$295,000 for a new home. So this gap between the medium prices of new and existing homes has widened in most markets across the country and in many cases is at the highest level that it's been in well over a decade. The dynamic that's causing in the marketplace is its forcing more buyers to go over to the resale market because the product that they can afford just isn't available in the new home market.

New home activity in Phoenix for 2015 made up 10% of the total home sales transactions. To give you some historical perspective, before 2009 it was 24% or more. We've gone from one out of four home sales in the market being new down to only one out of ten. The dynamic that's driving is demand is very strong at the affordable price points. That under \$200,000 price point buyer is getting forced over to the resale market and it's driving down the inventory and driving up prices. That's where we're seeing the highest appreciation rate.

In 2015, we actually saw a little bit changing in the trend. The gap between new and existing in 2015 flattened because existing homes rose faster and the medium price of the new home remained relatively flat. What's happening is we're beginning to see some of the more outlying submarkets start to activate more. This is a very natural progression in the recovery of a market. In Phoenix, as buyers are getting forced out of Chandler and Gilbert, submarkets like the Hunt Highway corridor and Florence saw activity jump 49% in 2015. Maricopa's up 28%. What's happening is those are some areas where we can still provide that product in the \$250,000 and below price ranges.

Let's move on and talk a little bit about the latest trends that we're seeing in traffic and contracts. We do a weekly traffic and contracts report in the Phoenix market. It's a voluntary reporting survey to our builder clients. Again, we began to enter a period where there's less favorable year over year comparisons because the surge in the traffic and contracts began in January 2015. The other factor is that we've seen a slight increase in the community counts throughout the year. So when we start to look at traffic, and we look at it on a per-community basis, there's a slightly higher level of competition.

When we look at traffic in January and February on a per-subdivision basis, we're seeing the numbers lag 2015 by a very slight amount. However, when we drill down into it and look at the net contracts in January, they exceeded 2015 because the cancellation rates in January were better in 2016 than they were compared to 2015. However, as we got into February, we saw that trend reverse itself where the net contracts in February of 2016 have lagged the net contracts that we saw in 2015. The reason for that is cancellation rates jumped during the month. Some of that may be due to a portion of the contracts that should have been canceled in January actually got pushed into February. We'll have to continue to watch this as we move forward to see if this is a trend or if this is just a little blip. When we look at the net effect over the first two months of this year, the net contracts in total were relatively flat on a per-subdivision basis.

**What does that mean in terms of our housing activity and what we're expecting? We had a very strong fourth quarter of 2015 in terms of year over year comparisons for net contracts. That should lead to continued strong starts in the first quarter. As you can see right now into January and February, that year over year comparison is flattening out. So we anticipate the starts' activity to begin to flatten out year-over-year.**

I want to spend a little bit of time on the inventory because I think it does paint a picture as to the health of the market. On the new home construction side, we saw new home inventory jump 50% during 2015 to 8,700 homes. That's the highest it's been since 2009. We also saw the months of supply jump to 9.3 from 6.9, so tremendous growth in inventory overall. We have to dig into the inventory to really understand what the health of that inventory is relative to the demand. This is exactly why we drive the subdivisions to get a visual observation of the status of that inventory. We go through and observe if it is a vacant developed lot



or are there houses under construction? We track the stage of completeness in the construction process and when it is occupied.

What we like to do is look at how much of that inventory is finished and vacant. When we look at finished and vacant inventory, it fell 30% during the year, down to 1,650 homes. That is the lowest level it's been since 2013 and is at just 1.8 months of supply. If you think of homebuilding like a manufacturing process, you want to have inventory in all stages moving through the construction cycle. What we see is that when finished inventory is low, that tells us that builders are having trouble keeping up with demand. When finished inventory is growing and approaching elevated levels, that tells us that builders are over-producing demand. Why we track this metric and think it's so important is it doesn't rely on builders reporting cancellation rates.

We always tell our clients watch this metric because it's going to tell you what's happening with the true demand. Finished inventory is falling. The ratio of finished vacant inventory to total inventory fell to 19%. That's a very low number and is indicative of a restricted market. Normally we would expect to see about a third of that inventory in the finished vacant category. So even though inventory's grown dramatically and currently represents 9.3 months of supply, the reason is because of the labor constraints and that the construction cycle has been extended.

What we're telling our clients is to watch the trends in finished vacant inventory and that will tell us whether cancellation rates are starting to spike up or if there are any issues. We'll be watching as we get into the second and third quarters as these homes that are stuck in that construction cycle get finished and make sure they're getting closed.

Finally on the lot inventory side, during 2015—and most of this happened in the second half of the year—lot inventory fell 3%. So inventory is continuing to get more restricted. We're seeing development activity expand. There are about 12,000 lots that were delivered in 2015, but that's below the starts pace, so inventory dropped during year. So we ended the year with about 52,000 lots. We always tell people that we have to drill down and look beyond that inventory because lots aren't always in the right location and at the right price point. There may be other issues that have to do with infrastructure that may be keeping those lots from hitting the market in large numbers.

We have in some areas what we've jokingly called "zombie lots". Those are lots that have been developed, the streets are in place, but there hasn't been any homebuilding activity in over a year and they've been developed for more than year. If we strip those out, there's only about 30,000 lots where any homebuilding activity is occurring in that subdivision. That represents 25 months of supply, which is about what we consider to be equilibrium. So you say, "supply and demand is in equilibrium." But you have to dig beyond that too because not all of those lots are located in the A locations where everybody wants to live. If we look at the top subdivisions that make up 75% of the activity, those subdivisions only contain 15,000 lots. About half the lots are accounting for 75% of the demand. That represents only 17 months of supply, so it's very restricted in those most desirable locations. Those lots are there to be replacing that inventory.

In 2016, we do expect to see development and lot deliveries pick up because when we're driving those future subdivisions, we're noting whether there's activity. If we look at those where the streets are getting excavated and paved, that would suggest that we would see more lots delivered in 2016. What does that mean for

the market? One of the reasons why activity is likely to begin to flatten out is that every time we're delivering a new community, the lot prices are increasing. I went back and looked at lots that were delivered back in 2014. I looked at 2014 vintage subdivisions and those subdivisions had a medium-base price of \$287,000 but only a 16-month supply. The lots that were developed back then are only going to last another year and a half. So as we get into 2017, they're going to be gone. 2015 vintage subdivisions had a medium price of \$307,000. In some of these submarkets where we're building those out, some of the buyers are getting priced out of that market and either getting forced over to the resale market or have to go further out to the periphery. **One of the dynamics we may begin to see in 2016 is activity beginning to flatten out in some of the most active submarkets, causing the next ring of development to activate more.**

Before we get into questions, just to summarize, 2015 job growth was very strong and helped consumer confidence. Unemployment is low, which is keeping demand very strong. The outlook for jobs looks good, barring some outside event. Everything in Phoenix looks good in terms of job growth, so the demand should remain strong. Now in terms of the makeup of the demand, we're not seeing a lot of speculative activity. Only 4% of the new home sales last year were not to owner occupants. Existing home inventory remains very low. Finished new home inventory remains very low. Total inventory is up so that will be worth watching. Those are all very healthy indicators of a continued strong housing market. When we look at challenges that we're likely to face in 2016, I think it's going to look a lot like 2015. Tight labor supply is likely going to continue to lead to rising prices. Extended construction cycle times, low lot supply in the desirable locations are going to continue to drive up lot prices squeezing affordability and potentially squeezing some margins if builders are not able to pass those on. **I think we're going to continue to see the trend of what have been the B locations becoming the new A and some of the C locations becoming the new B.**

**Participant Question:** Thank you for a very comprehensive presentation. Given the tightness at the low price range, I wonder if you could comment about the impact in multi-family and single-family rentals for that first-time home buyer and lower or moderate income households?

**David Brown:** That's a great question and not unique to Phoenix. It's a question that we're seeing in virtually all of our markets. The multi-family market has been on a tremendous run for the last 6-7 years now in most of the markets. Some of that has to do with the economy, but there are a lot of demographic shifts that are occurring with millennials. They are getting to the stage where they've been forming their own households, but they've been stepping into apartments. We're also getting to the stage, though, where we're going to see more and more now entering the age where they might be buying homes. That's why we've seen this larger increase in terms of activity at the affordable price ranges. Quite frankly, the challenge that we're facing is providing that supply.

We've had very few builders that have focused on it. Certainly on the public side you've seen D.R. Horton make a big push in this introducing their Express brand. LGI Homes is another one. We're beginning to see more and more of our builders who have focused so much in those move-up price points face increased competition in those move-up price points and getting pressure in terms of margins and ability to continue to raise prices to cover those increasing costs. Also, what's going to happen with interest rates is playing a role.

We're hearing more of our clients starting to focus on this more and more. Quite honestly, when you look at many of these markets we're building more homes than we've ever built in those move-up price ranges. This isn't the case in Phoenix. Our outlook for the next several years is that we're going to see continued strength in terms of the demand for those more affordable housing options and whether that's apartments, single-family rentals, existing homes, or new homes. The demographics all line up with that. When we look at the supply and demand characteristics, that's where we're seeing the biggest growth in potential demand as well as the tightest restrictions in terms of supply.

**Participant Question:** Do you have any data around what's under construction? What's in the pipeline for the next three years? Is it all class A multi-family or are there any lower priced options that would be offered?

**David Brown:** We don't do a survey on the multi-family market. In general—this is true of the new home market—you don't go build class B and C. You're building the A in any sort of market and then that expands. The dynamic we are seeing that quite frankly we probably need to see a bigger shift from is that in many of these markets there's so much concentration of multi-family in the urban and ultra-high-end rental range versus getting into the more affordable and suburban class A. That's keeping the supply constrained.

**Susan Maklari:** You talked a little bit about the labor constraints that the builders are seeing out there. Can you give us some more detail around how much costs are rising and how are builders responding to the fact that it's getting hard for them to get the crews that they need?

**David Brown:** Some of the conversations we've had over the last several months last year indicated that yes, it was adding costs, but as much as anything it's adding time. It's dependent upon the location and what you're building, but on average going up 30 days and 45 days in some markets. So it's not just labor costs that are getting driven up. It's now impacting your holding cost because of that existing construction cycle time. That's been a challenge. I don't see that showing dramatic improvement. There was a lot of speculation and hope that because of the oil markets some of the people that were in the oil fields that might have left the construction industry down the downturn might return. We're not seeing a widespread indication that is happening. There has been some easing in that are in some pockets, but it continues to remain constrained. I think what we're going to see is as starts and construction really ramps up, we're going to see those same kinds of constraints in the various trades based upon the inventory as it moves through that construction cycle.

**Susan Maklari:** Are you seeing builders try and start more homes a little earlier perhaps in anticipation of demand that's coming to try and stay ahead of things?

**David Brown:** Absolutely, yes. There were a few builders that did jump on starts a little bit earlier this year. Some builders have done that to try to get ahead of it a little bit. I don't think that's going to be enough to solve the problem. Just about every builder in the market got burned, if you will, by that longer construction cycle. We started to hear throughout the year they were revising their business plans and forecasts on closings downward, not because of demand, but because they were concerned about getting it finished in time and being able to get the homes closed before the end of their fiscal year or calendar year.

**Susan Maklari:** You mentioned that you're seeing some builders moving further out from core submarkets. Can you talk about the profitability that the builders are going to be able to realize as they do this?

**David Brown:** That's always been the challenge. The risk is that when you get out on the very fringe, if there's a pullback, that's also the area that gets impacted first. The reality is that if you're sitting in a market and the vintage of lots that you're building on today were at \$1,300 a front foot and now the next vintage is \$1,600 a front foot, not all those buyers are going to be able to jump up to the new higher price point. So it forces the builders to go further out where there might be some existing lots already developed on the ground where you might still be able to get them below what replacement cost would be today, or you're getting the cheaper land that allows for that lower price point.

It's a natural progression. In terms of margins, in theory there should not be that margin squeeze because you're building a less expensive lot. What's allowing that is where those buyers have been able to go to the resale market, those resale prices are getting higher. So a buyer has a choice of buying an existing home that might be 10 or 15 years old, or getting brand new product but I've got to drive 5 miles further down the road. As that equation begins to shift as existing home prices continue to rise, it's opening up locations that are further and further out.

**Susan Maklari:** You mentioned in your commentary that you look for starts to be up about 10% in this market for the year. When you think about all the different puts and takes in Phoenix, how do you think about the risks to the upside or downside to that forecast?

**David Brown:** In terms of the upside, it will be a challenge to see growth much higher than that. The reasons are labor constraints and lot supplies. We're sitting here right now with 17 months of supply of lots where 75% of the activity is. There are some of those communities that we may not get new lots on the ground fast enough and you could have builders slow some of their sales activity down so that they don't gap out until they get those replacement lots out there. We just don't have the lots on the ground today.

The second piece is with the replacement lots as they get delivered, prices are rising so that shifts the demand. We've heard this in some markets where there's been an increase of buyers that weren't quite ready to buy a year ago but shopped around and came back and now prices have jumped significantly and they no longer can afford in the community. Lastly, you have to look at the labor constraints. We are seeing labor grow, but it's not enough that would allow us to go build a significantly higher number. I think it will be really difficult for us to see growth be significantly higher than about 10%.

In terms of the downside, a risk would be if we saw a sudden spike in interest rates. I know we've seen before where interest rates bump 100-150 basis points and can cause a short-term hiccup. Something could happen in the economy that causes job growth to slow. An impact to activity that could cause it to come in below our expectation would be if we don't get the 50,000 jobs created and it's closer to 30,000.

**Susan Maklari:** I think we'll wrap it up there then. Thank you for the overview to everyone that's dialed in. We will be back in two weeks with our next update.

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

The primary risk facing homebuilders – including Beazer Homes, Lennar, PulteGroup, Toll Brothers, and Meritage - 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.

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12-Month Rating	Definition	Coverage <sup>1</sup>	IB Services <sup>2</sup>
<b>Buy</b>	FSR is > 6% above the MRA.	48%	36%
<b>Neutral</b>	FSR is between -6% and 6% of the MRA.	39%	28%
<b>Sell</b>	FSR is > 6% below the MRA.	12%	22%
Short-Term Rating	Definition	Coverage <sup>3</sup>	IB Services <sup>4</sup>
<b>Buy</b>	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
<b>Sell</b>	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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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
<b>Beazer Homes</b> <sup>16</sup>	BZH.N	Buy	N/A	US\$8.91	17 Mar 2016
<b>Lennar</b> <sup>7, 16</sup>	LEN.N	Buy	N/A	US\$47.23	17 Mar 2016
<b>Meritage Corporation</b> <sup>16</sup>	MTH.N	Sell	N/A	US\$35.74	17 Mar 2016
<b>PulteGroup, Inc.</b> <sup>16</sup>	PHM.N	Buy	N/A	US\$18.37	17 Mar 2016
<b>Toll Brothers</b> <sup>16</sup>	TOL.N	Buy	N/A	US\$28.78	17 Mar 2016

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

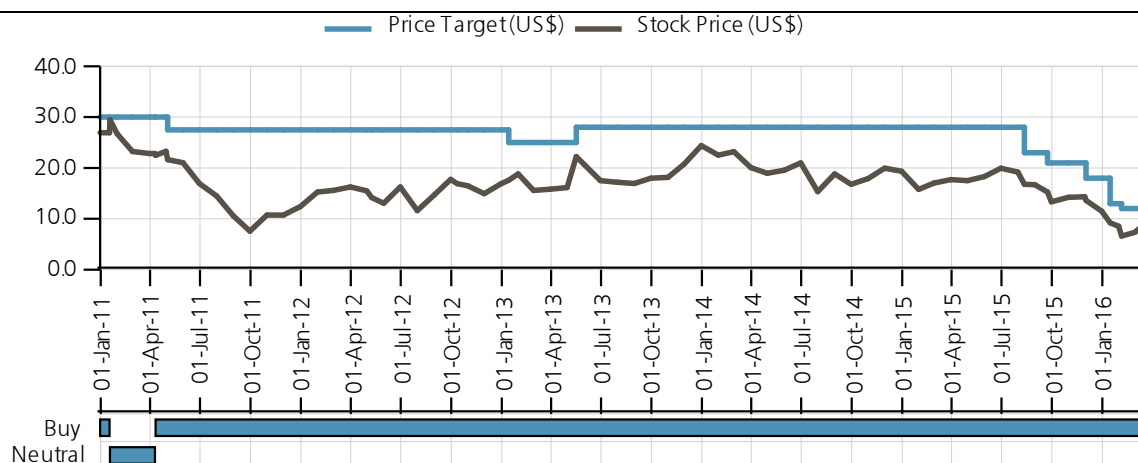
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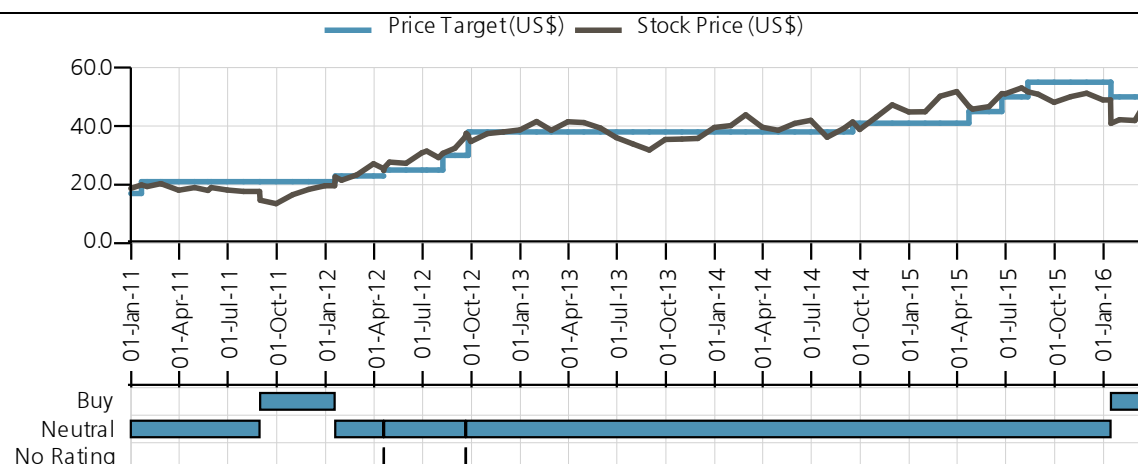
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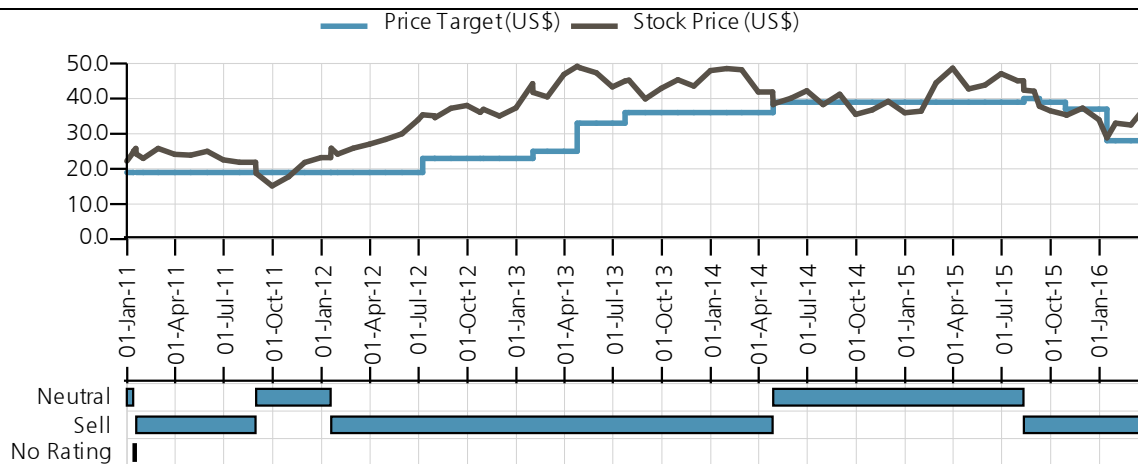
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### Lennar (US\$)



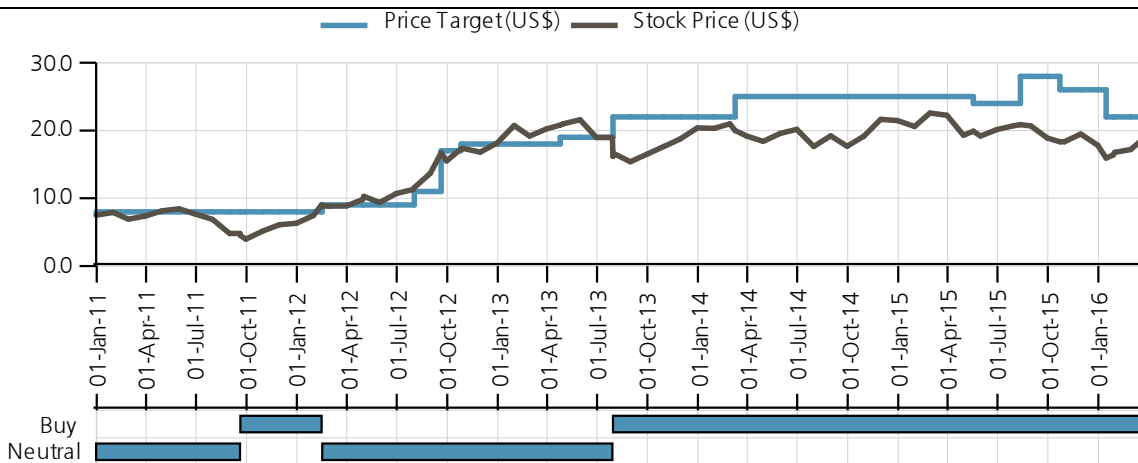
Source: UBS; as of 17 Mar 2016

## Meritage Corporation (US\$)



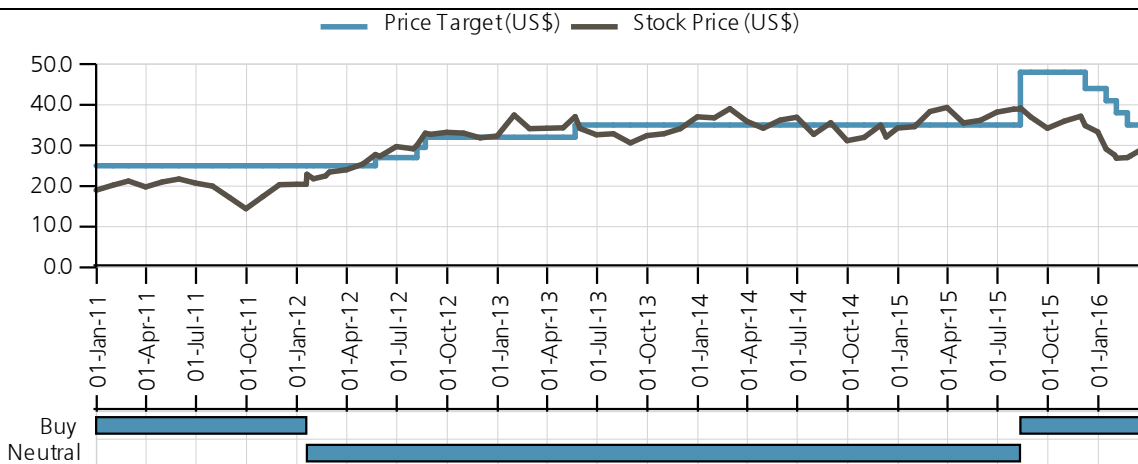
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