

U.S. Homebuilding

Southern California Call Transcript: Activity Moving Inland Slowly but Surely

Equities

Americas
Home Construction

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Moderate Growth Ahead Given Supply Constraints

To get real-time updates on conditions, we host calls with local experts across the country throughout the year. We recently spoke with Dennis Handler, Director of the Southern California market for Metrostudy, to get an on the ground perspective. Activity remained healthy in 4Q15 across Southern California with quarterly closings up 4.5% year over year. Further, on an annual basis, closings increased 10% in 2015 with starts up 5.5%. Volumes in the Inland Empire are picking up as well as affordability is less of a constraint and available supply to meet demand is greater. We'd note this area currently makes up nearly 60% of starts in Southern California as builders try to meet the needs of first time buyers.

Affordability Causing Builders and Buyers to Look Inland

Throughout the recovery builders maintained a focus on move-up buyers due their more attractive financial positioning. That said, as this segment appears to be reaching a relatively mature phase, it remains to be seen how much further prices can rise. We'd note as of 4Q, the median new single family home price was ~\$900,000 in Orange County. Further, given strong appreciation, there is now ~\$320,000 difference between new and existing homes here. This has in part acted as an incentive for builders to look to inland submarkets and optimize their product offerings.

Keeping an Eye on Labor Constraints

Labor constraints and costs of production are still front of mind. Depending on the vintage of land, maintaining elevated margins will be a challenge, especially in the Inland Empire where pricing power will likely be harder to come by. In our view, activity will continue to expand as the entry level and first time buyer segments gradually re-emerge and builders accept the tradeoff between higher volumes and price. We believe Buy-rated LEN will benefit from this given its presence in this market.

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 8x our 2017 EPS estimates and 1.3x our forecast 2017 book values. The stocks currently trade at 7.8x our 2017 EPS estimates and 1x our 2017 BV estimates. Our top picks in the group are TOL, LEN and PHM. We also highlight Buy-rated BZH.

Summary of Conditions

Fundamentally while conditions in the Southern California housing market remain favorable, affordability and loan qualification are issues, especially in the coastal markets. As a result, the trend of buyers gradually gaining interest in more inland submarkets continues to play out. That said, while this area will continue to be supported by strong job growth and limited supply in better located MSAs, the pace of increase will likely be more moderate until this transition accelerates. We provide additional color below:

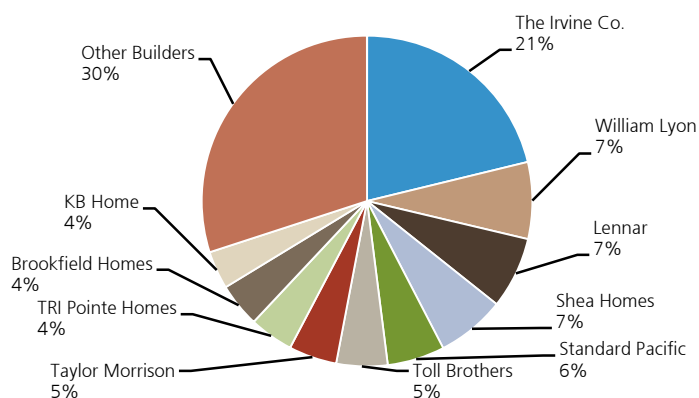
- Activity remained healthy in 4Q15 across Southern California with quarterly closings up 4.5% year over year. Further, on an annual basis, closings increased 10% in 2015 with starts up 5.5%. Volumes in the Inland Empire are picking up as well as affordability is less of a constraint and available supply to meet demand is greater. We'd note this area currently makes up nearly 60% of starts in Southern California as builders try to meet the needs of first time buyers.
- Throughout the recovery builders maintained a focus on move-up buyers due their more attractive financial positioning. That said, as this segment appears to be reaching a relatively mature phase, it remains to be seen how much further prices can rise. We'd note as of 4Q, the median new single family home price was ~\$900,000 in Orange County. Further, given strong appreciation, there is now ~\$320,000 difference between new and existing homes here. This has in part acted as an incentive for builders to look to inland submarkets and optimize their product offerings.
- Labor constraints and costs of production are still front of mind. Depending on the vintage of land, maintaining elevated margins will be a challenge. This is especially true in the Inland Empire where pricing power will likely be harder to come by. In our view, activity will continue to expand as the entry level and first time buyer segments gradually re-emerge and builders accept the tradeoff between higher volumes and price appreciation.
- Given these factors, our market expert believes growth will be moderate in 2016 across Southern California. Overall, he believes the market is 12-18 months away from first time buyers driving more significant volume growth.

Builder Presence: Operating Stats

Los Angeles

With approximately 6,900 new homes closed in 2014 (based on data collected by Metrostudy and reported as part of Builder Magazine's "Local Leaders" series), the Los Angeles/Long Beach/Santa Ana metropolitan area ranked as the 12th largest housing market in the country. In terms of market share held by the top builders, this area is similar to 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 70% in Los Angeles.

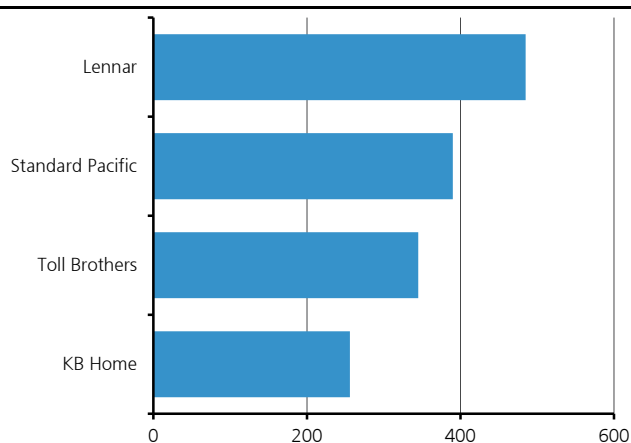
Figure 1: Share of 2014 Los Angeles Closings, by Builder



Note: Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy)

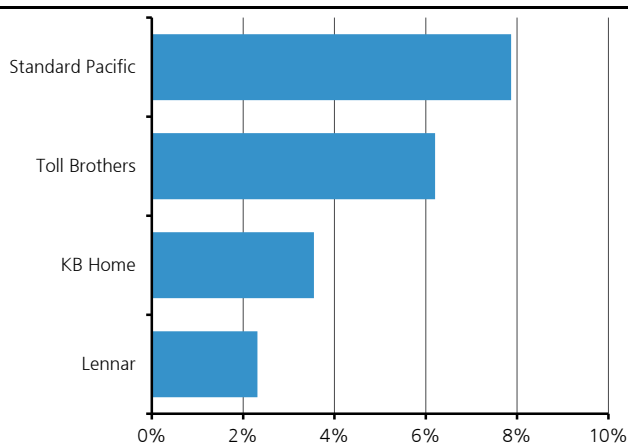
Although the builders' exposure to this area is limited—relative to their total closings—many of the public companies maintain a level of presence. More specifically, within our coverage universe, Lennar closed the largest number of homes here last year.

Figure 2: 2014 Los Angeles Closings



Note: Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy)

Figure 3: 2014 Los Angeles Share of Company Closings

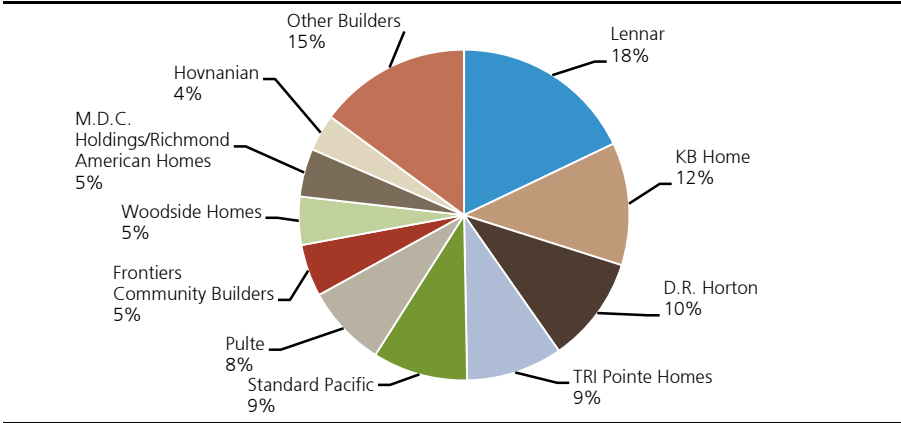


Note: Calendar year closings obtained from Builder Magazine. UBS divides these closings by closings per company reports for the four fiscal quarters most closely coinciding with the 2014 calendar year. Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy) and company reports

Riverside

With approximately 5,400 new homes closed in 2014 (based on data collected by Metrostudy and reported as part of Builder Magazine's "Local Leaders" series), the Riverside/San Bernardino/Ontario metropolitan area ranked as the 18th largest housing market in the country. In terms of market share held by the top builders, this area is much less 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 85% in Riverside.

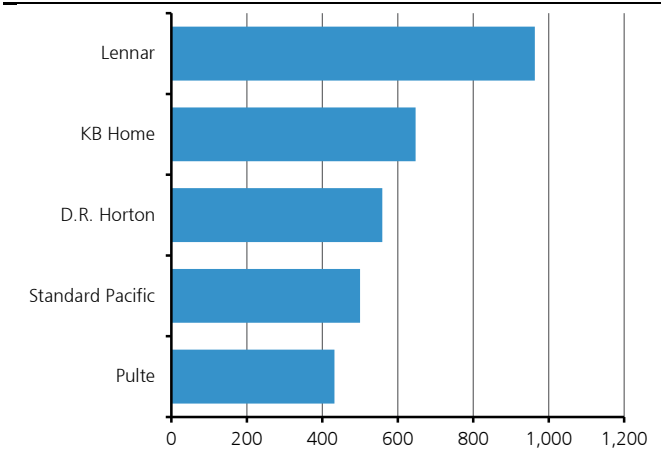
Figure 4: Share of 2014 Riverside Area Closings, by Builder



Note: Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy)

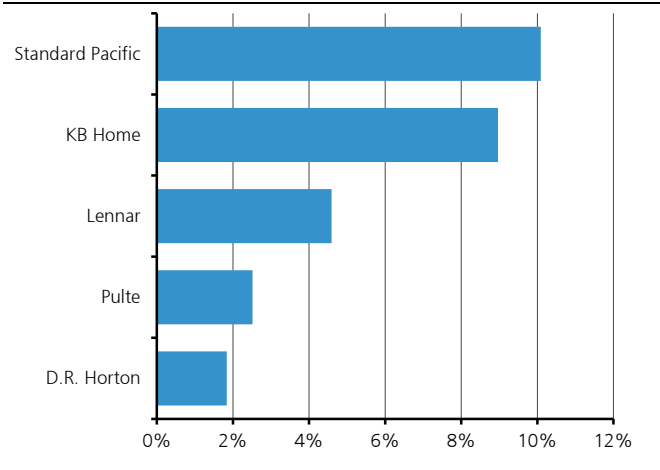
Within our coverage universe, Lennar closed the largest number of homes in the area in 2014. However, relative to total company closings, Riverside is a more important market for legacy Standard Pacific and KB Home.

Figure 5: 2014 Riverside Area Closings



Note: Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy)

Figure 6: 2014 Riverside Share of Company Closings

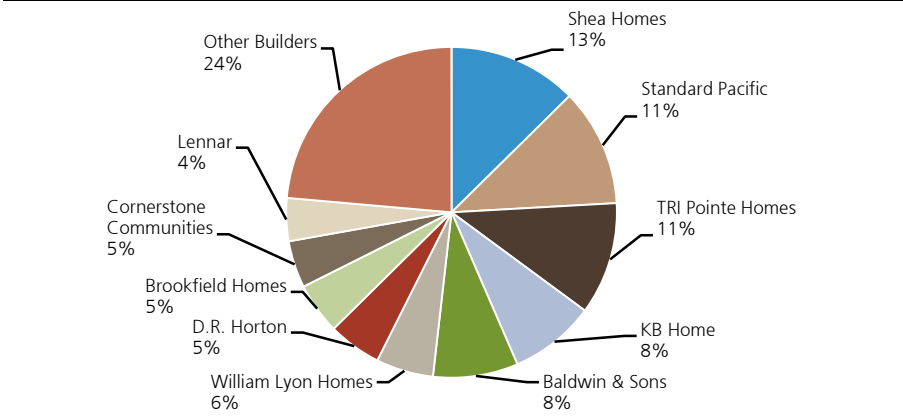


Note: Calendar year closings obtained from Builder Magazine. UBS divides these closings by closings per company reports for the four fiscal quarters most closely coinciding with the 2014 calendar year. Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy) and company reports

San Diego

With approximately 2,000 new homes closed in 2014 (based on data collected by Metrostudy and reported as part of Builder Magazine's "Local Leaders" series), the San Diego/Carlsbad metropolitan area ranked as the 46th largest housing market in the country. In terms of market share held by the largest builders, this area is less 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 76% in San Diego.

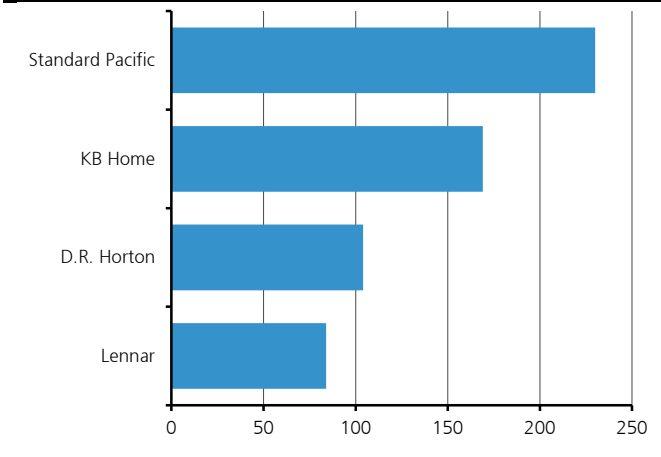
Figure 7: Share of 2014 San Diego Closings, by Builder



Note: Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy)

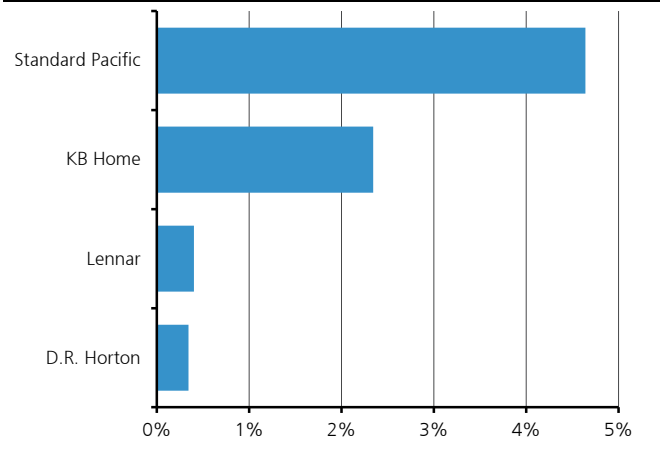
Although the builders' exposure to this area is limited—relative to their total closings—many of the public companies maintain a level of presence. More specifically, within our coverage universe, Standard Pacific closed the largest number of homes here in 2014.

Figure 8: 2014 San Diego Closings



Note: Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy)

Figure 9: 2014 San Diego Share of 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. Standard Pacific and Ryland merger closed October 2015.
Source: Builder Magazine (Metrostudy) and company reports

Conference Call Transcript

Below, we present the transcript from our call with Dennis Handler 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 for our call today. We're going to get an update on the Southern California market. This is an area that has seen lots of activity and price appreciation. With us today is Dennis Handler of Metrostudy to give us an update of what's been going on here. With that, Dennis, I will turn it over to you.

Dennis Handler: Thank you, everybody. I hope everyone's doing well. In general, I'll be talking about Southern California and in many cases I break it out by Los Angeles County, Orange County and Ventura County combined with the Inland Empire as one grouping that I'll call SoCal. I will then break out San Diego separately. In general, the Southern California market has been experiencing relatively stable economic activity. Consumer optimism is still positive. The economic environment is still fairly strong and improving as we move further and further away from the recession.

Housing affordability and loan qualifying remain major issues out here, especially at the lower price points. This obviously impacts new home sales for first time buyers. But overall, demand is extremely strong and supply is still fairly low. **We look for that demand/supply imbalance to continue for at least the next five years, which is favorable for builders and developers all throughout Southern California.**

Touching on some of the economic conditions out here, as I mentioned it's still extremely favorable. In LA and Orange Counties, we saw significant increases in number of jobs added. In 2014 almost 129,000 jobs were added to the market. In 2015 it's a little bit below that at around 112,000, but still a 2% increase year over year. Some of the big industries or sectors that fueled that growth included construction, which in 2015 in LA/Orange County had about 14,000 new jobs or up almost 7%. Trade, transportation and utilities added another 14,000 jobs. Professional business services added 19,000. A couple other of the major big ones included educational health services and leisure and hospitality, both adding over 27,000 jobs. Overall, the market's doing pretty well. In terms of unemployment, it continues to drop. As of 2014 we were at an unemployment rate of 7.2%. We dropped to 5.3% in the LA/OC job market. **They're projecting 3.8% as we move through the end of 2016.**

Ventura County is a much smaller market. They added about 8,500 jobs last year, or up roughly 3%. **Their unemployment rate has dropped from 6.6% down to 5.3% in 2015 and we're anticipating it's going to drop even further to about 4.3%.** The Inland Empire averaged about the same number of jobs added from 2014 to 2015 at just about 46,000-47,000 jobs in each of those years. This was an increase of about 3.5% year over year. Some of the big sectors out in the Inland Empire were construction, which added about 7,000 jobs or nearly 9% growth. Trade, transportation and utilities added 10,000 jobs and professional business services added 8,400 jobs. **The unemployment rate is expected to continue to drop. It's currently at 6.1% and moving through 2016 we're looking for an unemployment rate of about 4.7%.**

Looking at San Diego, they added 33,000 jobs in 2014. In 2015 they increased that to almost 38,000 or 3.3% growth. Again, some of the same industries that are showing positive growth include construction, professional business services and educational and health services. **Unemployment in San Diego has dropped from 6% to 4.8% in 2015. I anticipate even further improvement, dropping down to about 3.8% in 2016.**

In terms of household formations, overall the market has been very positive in LA. They've been averaging over the last five years, 0.6% growth in household formations. If you look at the last two years, it's been 0.7%. This growth pattern is similar across all of the markets in Southern California. The last two years are showing even greater growth. For example in Riverside, they averaged 1.5% growth over the last five years. In the last two years, it's now up over 2.2%. The same can be said for San Bernardino. It's now almost 2%. Over the last five years it's been about 0.9%. You can see that there is more activity moving into the Inland Empire with more and more folks exploring the options of further commutes. There's a much greater supply of product to choose from out in the Inland Empire.

The other part of this equation with regard to household formation is median income. They have been steadily rising over the last couple of years. It's been averaging about a 2% increase for LA County. Over the last five years it's been about 1.5%, so it's not really until recently that we've seen some significant increases in household income across the various counties of Southern California. Riverside in particular, has seen a jump over the last five years in their household income. It's been averaging about 1.5% in the last two years. It's now close to a 4% improvement in household income.

Let's switch gears and look at the resale market to give you a flavor for what's going on there. Roughly 85-87% of closings occur in the resale market. Compare that to roughly 4% for new homes depending on where you are in Southern California. The balance is made up of REOs and foreclosures. In general, the resale market has done well year over year. We saw the number of units sold increase 3% since 2014. In Los Angeles County, they had 44,400 closings compared to 43,000 in 2014. The median price bumped up about 3%.

In Orange County, we saw a 15% increase in the number of closings. Ventura was up about 16%, Riverside saw a 10% rise, San Bernardino was up 14% and San Diego saw almost a 32% increase in resale closings, albeit in a much smaller market than the rest of the Southern California areas. But there were pretty significant improvements. Overall, Southern California has seen about a 4.1% change in average median sales prices across all of the major counties here. The largest increase was in San Bernardino at roughly 5.6%. Riverside was up 3.9% and Ventura increased 6.2%. I'm talking about single family homes in these counties.

Let's switch gears and look at townhomes. They have also seen strong positive activity year over year in terms of number of units sold. Los Angeles has seen an increase of 9% in the resale market for this type of product. Orange County was up almost 8%, Ventura has seen an increase of almost 29% and San Diego rose almost 46%. The percentage change in average median price for townhomes has increased 7.5% across all of the counties in Southern California. Overall, the resale market is doing very well as it is controlling a larger market share. Also, there's much more to choose from, which is giving buyers more opportunities to explore

options in the resale versus the new home market and that has had an impact on sales for new homes. But it's still showing some good activity that buyers are coming back into the market. They're still feeling positive and starting to throw their hats into the ring if you will.

For all the major markets here I'll talk about single family versus multifamily. For LA County, there's about a 4:1 ratio of multifamily permits being pulled relative to single family. In 2015 we had nearly 19,000 permits pulled for multifamily as compared to 4,700 for single family. Orange County is basically the same. They're favoring multifamily permits roughly 2.25:1 at roughly 7,100 multifamily permits relative to 3,200 single family permits in Orange County. The Inland Empire is the opposite. They're actually 3:1 favoring single family permits to multifamily. In 2015 they had almost 6,100 single family permits pulled relative to 1,700 multifamily. San Diego is roughly a 2:1 ratio of multifamily to single family.

If we look at affordability and existing versus new home prices, the LA/Ventura County markets have a median price for a new home in the \$550,000-560,000 range. This compares to the resale market sitting right around a \$500,000 median home price. That's roughly a \$45,000-50,000 difference between what's available in the new home market relative to the median price in the resale market. In terms of affordability, existing is just above the new home market, sitting right around 28% of consumers who can afford to buy an existing home. For the new home market roughly 25% can afford to buy in the LA/Ventura County areas. This is based on some basic assumptions, including a 30 year mortgage, 20% down and using the median income levels and current interest rates, tax and insurance.

Looking at Orange County however, there's a huge discrepancy between what people can afford on the new home side versus resales. There's almost a \$320,000 difference between the average median price with new homes currently at a little over \$900,000 in Orange County. Compare that to the resale market, which is just about \$600,000. There's a huge difference between what people have to choose from in terms of new homes being built relative to the resale market. In terms of affordability, 30-32% of homebuyers can afford a resale product relative to about 17% of buyers that can afford a new home. So there's a significant difference between what folks can afford in Orange County relative to what they're seeing in the Inland Empire as well as LA County.

In the Inland Empire, the median price is right around \$420,000 for a new home product compared to \$275,000-280,000 for a resale. There is about \$120,000-130,000 difference there. Those that can afford a resale home is approximately 50% relative to about 32% for a new home.

The same story goes for San Diego as well with almost a \$190,000 difference between the median price of new versus resale. A lot of this has to do with what is being built out in these areas and why there is such a significant difference. In Orange County there's a lot of product being built that's over a million dollars. In San Diego there's a lot that's over \$900,000 so it's pulling up the averages. That said, we are also seeing that there's a lot more high density, smaller, zero lot line, townhome type products coming into the marketplace. This will help bring down that difference between new and resale.

I'm going to take a jump and look at sales and traffic across Southern California. It's been a tough market as it moves laterally. It's not necessarily moving in a nice upward, exponential growth pattern. It's been fairly flat for the past year. We've had positive numbers but not necessarily increasing percentages of growth over

the last 12 months. It's reflected in the contracts, traffic, conversion rates and the cancelation rates.

Typically over the year, builders have been very happy with perhaps one contract per week. But it's been slowly declining since the early part of last year. It's currently sitting right around 0.6-0.7 per week. This of course varies depending on where you are throughout the Southern California market. In some places it could be over 4-5 contracts per subdivision per month. In other places it may be as low as 0.5-1 per month. It really depends on the type of product, the price point and the location on how well you're performing.

In terms of traffic, we're typically within 45-50 registrations per week per subdivision. Through the end of the year we started to see a drop, which is part of a cyclical pattern that we typically expect. It declined to about 30 registrations per week. We're anticipating that it'll bounce right back up here within these next couple of months to springtime averages in the 45-55 range. Conversion rates have been fairly steady at 1.5%. The early part of last year we were looking at numbers close to 2% conversion rates. Again, very similar to contracts, you'll see a higher conversion rate as you move into the coastal communities or perhaps even into the active adult type developments. Areas like Coachella Valley have higher levels of conversion rates.

In terms of cancelations, this is an area of concern because it has jumped from roughly 12-15% in the early part of last year up to 23% by the end of 2015. This ranges again depending on where you are. It can be as low as 10% in A-rated locations. It may even jump as high as 37%, which I've seen in areas that are a little further removed from the major metros. Places like Lancaster are seeing high levels of cancelation rates in that 37% range.

Let's take a quick look at starts and closings. I broke this out by detached and attached. I'll talk about detached first but overall, the Southern California market is seeing a nice increase in the number of closings. **From the third quarter to fourth quarter, we saw an increase of 12% in closings. The year over year annual change was roughly 4.5%. Annual closings are up 10%. Our annual starts are up 5.5%.**

We like to keep an eye on finished inventory, which are homes that are basically move-in ready. Builders don't like to see a lot of this standing around of course. But any movement, any type of increase is something that we keep an eye on, especially if it's consistent over a couple of quarters. It gives us an idea of how well builders are actually selling and managing their product inventory. It is down roughly 3.5%. The number of units under construction that will be ready for completion within the next six months, is up about 25% from the end of 2014 to 2015. So production is up in Southern California. Vacant developed lots, which is the pipeline of new lots that are being prepared for vertical construction, are down almost 3%. That has a lot to do with the lack of availability of land and opportunities throughout Southern California, especially in the bigger counties like LA and Orange. As you move further into the Inland Empire, the vacant developed lots are much more abundant.

In San Diego, annual closings for detached product are down roughly 6%. Annual starts are up 30%. There's a lot more activity in San Diego as well. The percentage of inventory is starting to ramp up. If you see that the closings are starting to slow down, which we have seen in San Diego and the LA/Orange County areas, we've got to keep an eye on what's going on with their inventory

levels. It looks like they're beginning to come up while their closings are starting to pull back just a bit. Builders are keeping an eye on these numbers. They're taking a very cautious, measured approach to how much inventory they push into the marketplace. But there still seems to be a fairly positive outlook on what's expected here in 2016.

Looking at each of these counties, LA has seen annual starts of about 1,730 in the fourth quarter of 2015. They make up roughly 14% of the total starts in Southern California. Orange County currently makes up about 25% of the annual starts followed by Riverside at nearly 39%, San Bernardino at 19% and Ventura County at 3%. In terms of closings, LA County has about 15% market share, Orange County at 23%, Riverside at 42%, San Bernardino at 17% and Ventura at 3%. You can see in terms of market share of activity, the bulk is in the Inland Empire. Roughly 58% of annual starts are taking place there and nearly 59% of closings are in this area.

In terms of future inventory, we're looking at almost 450,000 lots scattered throughout Southern California, of which 60,000 or 13% are in some form of active future developments. Meaning there are stakes on the ground, there's equipment and excavation. That 60,000 is basically the pipeline of potential units that will be coming to the market. In San Diego, I broke this out separately. There are roughly 76,000 future lots of which 14,500 have some sort of activity on it and will be coming to market in the future.

Who are the top builders in terms of starts and closings in Southern California? Leading the way with 1,850 starts is Lennar, followed by KB Home at 1,033, Standard Pacific at 857, D.R. Horton at 665 starts and Pardee at 594. Closings more or less fall in line with that same order. The only difference is D.R. Horton switching with Standard Pacific for the third position. For San Diego, Standard Pacific leads the way with 374 starts, Pardee at 347 followed by Shea, Taylor Morrison and New Pointe Communities. Again, the closings follow that same pattern.

Overall, if I were to rate the market on a scale from 1-5, with 5 being best, I still see it being right around a 3. Builders and developers are cautiously moving forward. They're taking a very close look at who their buyers are, where they are coming from and how to attract them. I'm sure you've probably heard a lot about consumer segmentation studies being done. That is exactly what builders are having to do now, especially as the market gets more competitive moving forward. You're going to see a lot more development coming into play right next door to you. Traffic studies are a huge deal as well. We've got a lot of issues with traffic. Freeway and highway construction, especially the Inland Empire, are impacting sales performance at builders' subdivisions.

We're also looking at land optimization studies as a way to evaluate the types of products, the number of units on a particular site, understanding price points and what's going to move in a market. Also, how do we phase our developments? How do we receive the highest level of value from our investment? These are some of the major things that builders are starting to integrate into their strategies. They're also looking at consumer demand and really understanding who they are and what are they buying. What is the landscape of that consumer segment going to look like moving forward in the areas that they've purchased land? They are starting to consider what type of products they need to build and at what price point.

But overall, the Southern California market is moving at a moderate pace. We're seeing some decent momentum but builders are still moving at a cautious pace. Inventory is still available. The pipeline of vacant developed lots is out there in the Inland Empire. It's not as available in the coastal communities.

I think we're about 12-18 months away before we see any type of significant traction in the marketplace as the financial services industry starts to bring in a diversified portfolio of mortgage products to help spur growth at the first time end of the buyer spectrum. I think we're just sitting idle, waiting for things to spark here in the first quarter of 2016, perhaps even second quarter. With that, I'll turn it back over to you, Susan. Thank you very much.

Susan Maklari: A lot of your commentary was focused on the fact that affordability is an issue and we are seeing demand move towards the Inland Empire as a result. As the builders look to the upcoming selling season and 2016 in general, can you talk about how they are trying to improve the affordability of their product? Are they changing the kinds of homes or communities that they're going to be opening this year?

Dennis Handler: It depends on the location. Depending on where the builders were able to pull down some good land opportunity will help determine what type of product that they're building. For example, in areas near Chino and Southwest San Bernardino, it's more of an exclusive area. It's still the Inland Empire, but they can justify a higher price point. As you move further down the I-15 corridor into areas like Corona and Temecula, those are harder to sell areas. But that is where you're going to get those first time and first time move up type buyers.

Builders realize that's the basis for significant growth going forward. It is going to be the millennial buyers and there are even a lot of first timers still that are Gen X. There are a lot of folks that are sitting on the sidelines or in a rental situation. Nearly 20% of households are renters in the Inland Empire and sometimes even higher than that in certain parts. Builders are adjusting their portfolio downward and looking at smaller product. In fact a lot of single stories are coming back into favor. That's a high preference for a lot of buyers. We're looking at higher density, smaller, low maintenance type products on smaller lots.

Builders are definitely considering staying within certain price parameters because there is a sweet spot that will do well and have been doing better than others. For example, in the Inland Empire the new home market average price is about \$400,000. Compare that to the resale price at \$280,000. There's a lot of product out there that buyers have to choose from on the resale side and that's competing directly with the new home product. A lot of the resale market was built within the last 15-20 years in similar locations. There's also a tendency for buyers nowadays to go back to that old school retro feel home like a ranch style and fixing them up and not necessarily buying new.

Builders are ratcheting their portfolios accordingly and trying to keep their price points down as much as possible. There are certain builders that have done extremely well with their small product lines. For example, D.R. Horton with their Express product has done very well. In some cases I've heard that certain portfolios below the \$400,000 price point are now up over 80% out in the Inland Empire, which used to be a little bit more diversified but now is shifting towards that lower price point to spur that growth.

Susan Maklari: Can you delve a little bit more into the trends and any changes that you're seeing at the higher price point? For example, the \$800,000 to \$1 million plus range? Have you seen anything that's changed in that segment?

Dennis Handler: At that level it's a different spec level type of buyer of course. Value is key. Price and location are the two most important factors right now that we're seeing. Of course a lot of folks still want to see a certain level of amenities within the home and the community. I think the community feel is very important for those higher end buyers, especially in the master plans where you're getting a diversity of product, but there are a large proportion of higher end homes as well.

They like the rec centers with all of the service amenities such as bars and restaurants or coffee shop type stuff. They like their own pools. A lot of folks are not dealing with the upgrades and the improvements themselves. They're having it done before moving. Affordability is obviously more prevalent in that higher end of the price spectrum. There's less cancellations at that end of the market. If you move into areas like Orange County and even San Diego, there's still a significant number of closings and starts taking place in that \$900,000 and million dollars plus range, which to me is surprising. It's indicating that there's still high demand at that level. At some point, I expect they're going to hit a ceiling in those areas.

Participant Question: I appreciate the commentary. Can you comment on what you're seeing in terms of land and labor inflation in the Southern California market in general? Is there any disparity amongst the counties? Also, do you think that's going to be offset by home price appreciation in terms of a builder gross margin perspective? Longer term, do you see some of the labor and land issues as a structural problem or a cyclical problem?

Dennis Handler: Unfortunately inflation is not growing at the same rate as the cost of production, which includes labor and materials. That's definitely a major concern, specifically if we were to look at the Inland Empire where margins are always top of mind. A lot of builders got out there and perhaps took down their land positions at some higher price points so margin is extremely critical.

A lot of builders are finding it difficult to maintain their margin levels and keep prices where they are. It's definitely having a significant impact on a builder's ability to play with prices to increase activity and performance. Land is tight in some areas. Also, builders are very hesitant to take down larger lot positions. I'm sure you've heard this story. They're holding tight with what they've got until they can develop some sort of momentum get some cash flow before they start looking at other land opportunities.

I think the bottom line, like you alluded to, is that the cost of labor, the availability of labor and the cost of materials are having a significant influence on how builders push forward. Price appreciation is not keeping pace with those cost increases.

Susan Maklari: Have you seen any impact on either closings or build times due to the El Nino effect that we've heard a lot about this year?

Dennis Handler: No, not really. Not like you would see in other parts of the country like Texas. Now we're probably going to start seeing more on the East Coast. Construction times have been fairly consistent. I wouldn't say that there's been any extension outside of it being more of a builder decision to extend a construction cycle a little bit until they got the sales momentum moving. There are other issues that are going on out here.

You probably heard of Porter Ranch, but that's a very specific issue that's causing problems for part of Ventura County and a couple of builders out here.

Susan Maklari: Porter Ranch was actually going to be my next question. Can you talk a little bit about what's going on there?

Dennis Handler: It makes the nightly news of course. Toll Brothers is the major player out there that controls a significant number of lots. They've got a couple of big phases coming through in the next couple of years. They've been a major developer for Porter Ranch, which is the northern part of the San Fernando Valley above North Ridge, Granada Hills, Chatsworth and that area. I'm hearing that cancelations are on the rise.

It's impacting sales and traffic is down. It's even impacting the resale side of the market. Until they can get it all figured out, people are moving West or perhaps further down into the valley. I don't know when the gas leak will be fixed. There's no clear end in sight as of yet.

Susan Maklari: Are builders offering any accommodations to either people that have purchased their homes or for prospective buyers?

Dennis Handler: I don't know and I can't even venture a guess on that yet. That's something I'll definitely have to look into.

Susan Maklari: Okay. Is there any sense of when they expect to have the leak stopped or at drastically slowed?

Dennis Handler: It's been a while since this came up. It was probably 4 months ago that it made the headlines. At that point they were saying we should have some idea of how to fix this within the next 6 months. Honestly, 4 months down the road, I still don't think they have any idea of how to fix it or how big the issue is. This could go on a lot longer than we anticipate. The good thing is that we had decent rain out here that dampened the air and helped clean it out a bit. But it doesn't wash away the problem if you will.

Susan Maklari: I think we'll wrap it up there. Thank you for that very thorough overview. It was helpful for us to get an idea of what's going on in Southern California. And thank you to everyone that has dialed in. We will be back next week with another update call.

Valuation Method and Risk Statement

The primary risk facing homebuilders, including LEN, PHM, TOL and BZH, 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 price targets for LEN, PHM, TOL and BZH are based on a blended valuation methodology using an average of 8x our 2017 EPS estimates and 1.3x our forecast 2017 book values.

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Buy	FSR is > 6% above the MRA.	48%	36%
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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\$8.65	28 Jan 2016
Lennar ^{4, 6, 7, 16}	LEN.N	Buy	N/A	US\$41.28	28 Jan 2016
PulteGroup, Inc. ¹⁶	PHM.N	Buy	N/A	US\$16.39	28 Jan 2016
Toll Brothers ¹⁶	TOL.N	Buy	N/A	US\$26.84	28 Jan 2016

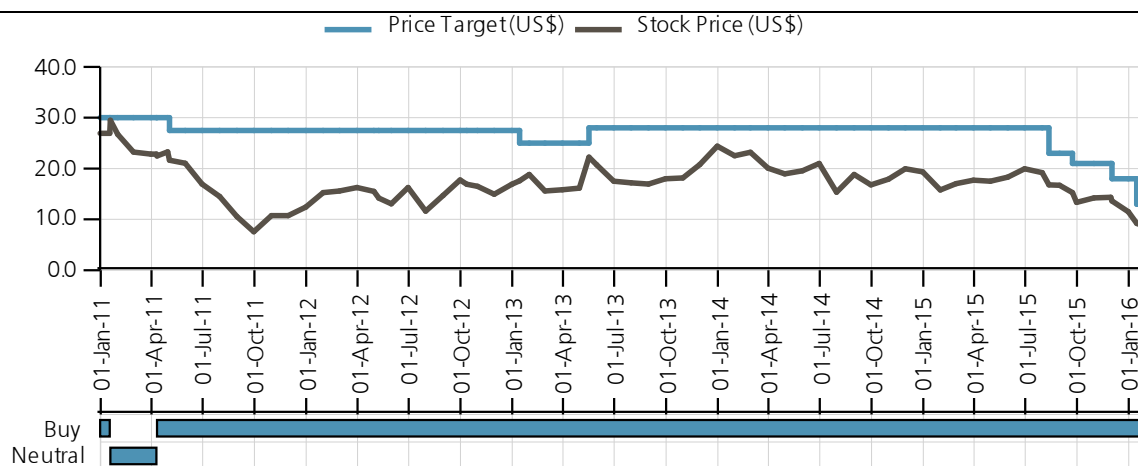
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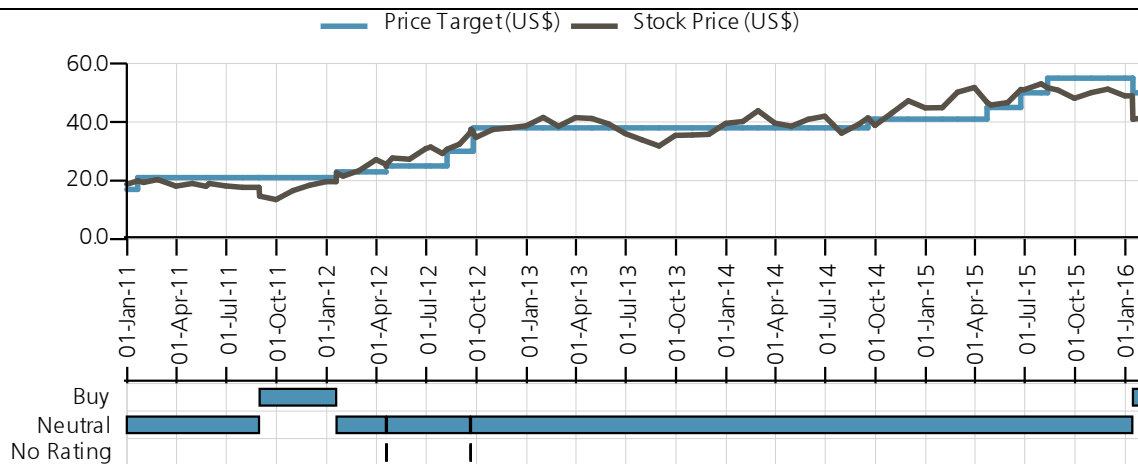
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Beazer Homes (US\$)



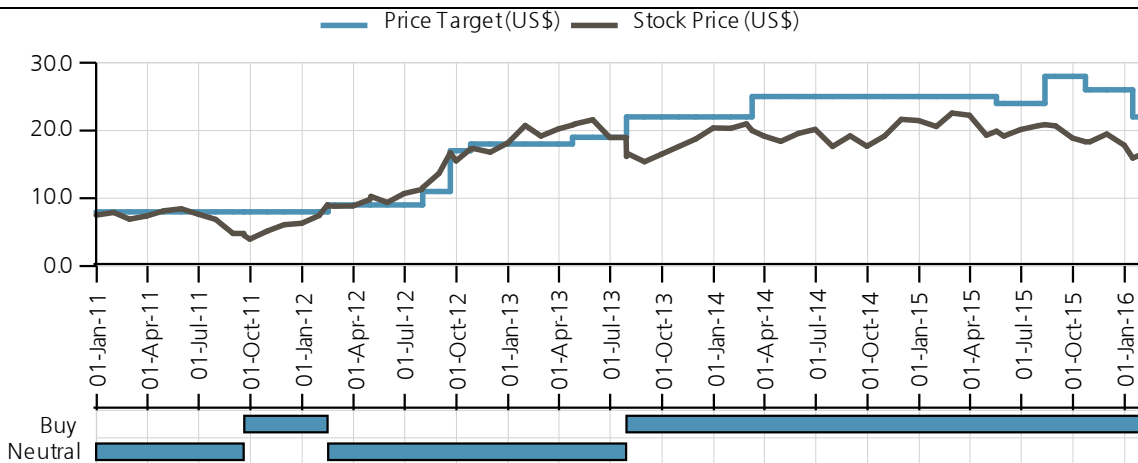
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Lennar (US\$)



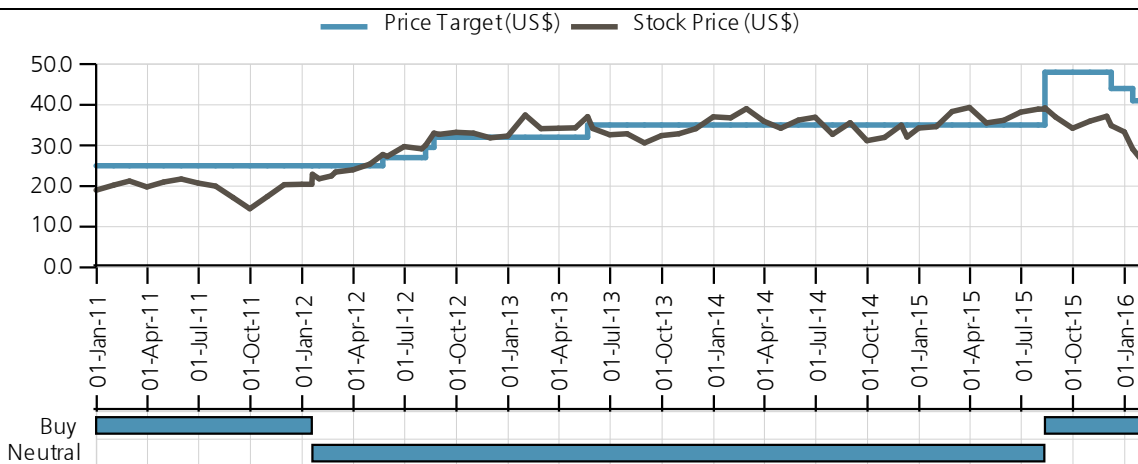
Source: UBS; as of 28 Jan 2016

PulteGroup, Inc. (US\$)



Source: UBS; as of 28 Jan 2016

Toll Brothers (US\$)



Source: UBS; as of 28 Jan 2016

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