



THE BIG BUILDUP

Home builders are on a tear and could be for years to come. Why this housing boom is different than before.

STORY BY ANDREW BARY

PHOTOGRAPHS BY MATTHEW JOHNSON

Housing is booming. Just take a look at Century Communities' development in Tumwater, Wash., where more than 140 homes, at prices as high as \$500,000, have been sold this year. Tumwater is viewed as a suburb of Seattle—even at 60 miles away. It's a scene that has been repeated over the past two years in markets all across the country.

Are we nearing a peak?

No, say the housing bulls on Wall Street, who argue that this is an upturn that could last for a decade. Millions of millennials are now at a point in their lives when they are seeking single-family homes in the suburbs and exurbs. They are entering a market still chastened by an unprecedented collapse in housing more than a decade ago.

"This market is primarily driven by a lack of supply, not excess demand," says Stephen Kim, a housing analyst at Evercore ISI. "The supply shortage built up over 10 years, and it won't go away quickly."

The numbers support Kim's assertion. Inventories of existing homes remain near historically low levels. Construction starts on new single-family housing, meanwhile, will finally top one million this year after averaging fewer than 750,000 in the previous 10 years. That would still be below the 1.6 million annual starts from 2004 to 2006, the peak years of the housing bubble.

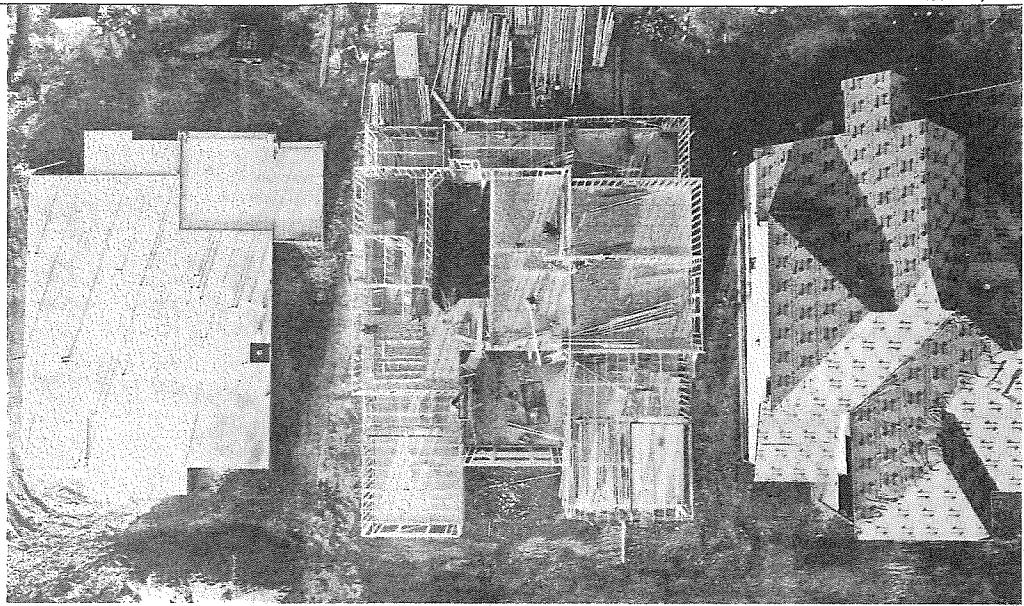
"The industry would need to sustain a two-million-starts pace for a decade to bring the industry out of its current underbuilt situation," Kim argues.

The large home builders—D.R. Horton (ticker: DHI), Lennar (LEN), PulteGroup (PHM), and Toll Brothers (TOL)—are well positioned to benefit from the demographic trends. Their stocks trade for an average of just seven times projected 2022 earnings, among the lowest multiples in the stock market.

Small-cap builders Century Communities (CCS) and Meritage Homes (MTH) are even cheaper, fetching about five times forward earnings. The S&P 500 index trades at more than 20 times estimated 2022 profits.

"The industry is completely different than it used to be," says Bill Smead, a manager of the Smead Value fund, which holds D.R. Horton and Lennar. "It's going from being fragmented to being aggregated in a rela-

Above: an aerial view of a Toll Brothers' development in Leander, Texas, just north of Austin. The previous pages show the same site.



Raise the Roof on These Stocks

Here's how some leading U.S. home builders stack up.

Home Builder / Ticker	Recent Price	YTD Change	2021E EPS	2022E EPS	2022E P/E	Dividend Yield	Price/Book	Market Value (bil)
Large-Cap								
D.R. Horton / DHI*	\$102.56	49%	\$11.41A	\$14.22	7.2	0.9%	2.5	\$36.6
Lennar / LEN**	113.11	48	14.53	14.65	7.7	0.9	1.7	34.2
PulteGroup / PHM	52.49	22	7.18	9.15	5.7	1.1	1.9	13.3
Toll Brothers / TOL***	68.51	58	6.16	9.04	7.6	1.0	1.7	8.3
Small-Cap								
Century Communities / CCS	\$77.22	76%	\$14.02	\$15.45	5.0	0.8%	1.6	\$2.6
Meritage Homes / MTH	118.04	43	19.15	23.12	5.1	None	1.6	4.4

*Sept. fiscal year end. **Nov. fiscal year end. ***Oct. fiscal year end. E=estimate. A=actual. Sources: Bloomberg; FactSet

tively small number of publicly traded hands, and there is a secular growth story due to demographics that mutes a lot of the normal cyclicality."

Nineteen publicly traded builders now command more than 30% of the new-home market, against 21% a decade ago. The builders have strong balance sheets and less land inventory, and are poised to ramp up capital returns to investors in the coming years. Dividends, now averaging just 1% across the industry, should rise along

with share repurchases.

In the past, home builders plowed profits into land purchases to enable future construction. That kept a lid on valuations, as investors worried that land-heavy balance sheets would become liabilities in a downturn.

Home builders are now reaching deals with land developers that give them the option to purchase home-building lots rather than buying and holding land. At Horton, the percentage of owned lots has fallen to 24%

from 43% since 2018.

"It's not like the top of the last cycle, when home builders owned a ton of lots purchased with borrowed money," Smead says. The companies, he says, have gone from being "land developers" to "home manufacturers"—increasing returns and lowering risk. Pulte has scarcely any net debt, and Horton has little net debt at its core home-building business.

J.P. Morgan analyst Michael Rehaut has estimated that the average net

debt-to-capital ratio on home builders' balance sheets will fall to a negative 4% by the end of 2023 from 15% today.

He sees the companies as capable of buying back 20% of their shares in the next two years. The repurchases have already ramped up. Pulte bought back 4% of its stock in the first nine months of 2021, and D.R. Horton repurchased 2% in its just-completed fiscal year.

Barron's has written favorably on home builders this year, including articles on Toll in January and Lennar in June.

Most public builders focus on entry-level and move-up buyers on the outskirts of major cities with average selling prices around \$400,000. Toll, however, focuses on the high end and has an average selling price of close to \$900,000.

Smead sees annual earnings growth of 10% to 15% on average for the home builders over the next decade, although the gains could be lumpy.

Evercore's Kim says that 2022 Street earnings estimates are too low, arguing that current earnings reflect homes ordered several quarters ago, when prices were lower and the cost of lumber, a major input, much higher.

"The supply-chain disruptions have pushed some of the upside into next year," he says.

The stocks aren't trading as cheaply based on price-to-book ratios, a popular valuation measure for home builders. The group now averages about 1.4 times projected 2022 year-end book value. Bulls argue that earnings are more durable than in the past and that the stocks should trade based on earnings and not book value.

Smead's view is that the persistently low valuations reflect the searing investor memories of the 2004-07 housing bubble and subsequent crash, when stocks like Toll and D.R. Horton fell as much as 85%.

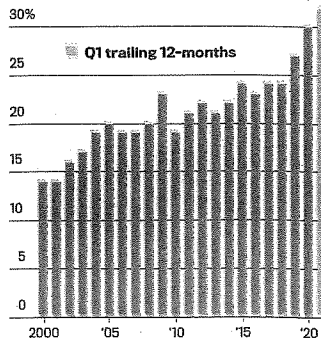
"If you compare this with the 2007-to-2009 period, you have two large demographic groups—millennials and baby boomers—looking for housing and not finding a lot of supply out there," says Jay McCannless, the housing analyst at Wedbush Securities.

The work-from-home trend is another favorable trend, as Americans move out of apartments and into single-family homes, while homeowners seek larger houses with home offices and other amenities.

The bear case for housing is that slowing population growth will limit demand, according to Zelman & Associates, the firm headed by the influential housing analyst Ivy Zelman.

The firm projects that the U.S. population will grow at just 4% in the current

Publicly Traded Home Builders' Market Share of Single-Family Housing Starts



Sources: Census Bureau; Evercore ISI; company reports

decade, down from 7.4% in 2010-20, which was the second-lowest percentage gain in history. "Population growth—the crucial underpinning of incremental housing demand—is on a troubling trajectory," the firm wrote in a report this summer. "The current pace of production already surpasses demographically supported normalized demand."

More near term, there is concern that the critical spring selling season next year may not be as robust as 2021's, particularly if ultralow 30-year mortgage rates, now just over 3%, rise toward 4%. The rally in housing prices may have already stalled. The S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index showed a 19.5% annual gain in September, down from 19.8% in August.

Industry executives say they aren't worried. "I think it's pretty clear that the market is not as white hot right now as it was in the spring, but we're still seeing very strong demand," said Michael Murray, co-chief operating officer at D.R. Horton, on an earnings conference call in November.

Dale and Robert Francescon, the co-CEOs of Century Communities, tell Barron's, "With interest rates still at historic lows, demand has been consistently strong throughout our national footprint of more than 40 markets."

And a bit of a cool-off may not be such a bad thing for the red-hot housing market, says Larry Pitkowsky, manager of the GoodHaven fund, which owns Lennar shares. "A more normalized pace of demand might be better, as Lennar and its brethren are striving to balance very strong demand with higher raw materials and tight labor markets, and a sensible desire

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to protect margins," he says.

Here's a closer look at six home builders:

D.R. Horton

The industry leader constructs roughly one in 10 new homes in the country—over 80,000 in its latest fiscal year. It has the industry's largest market value at \$37 billion and one of the highest returns on equity at 31%. Entry-level homes account for about half of its business.

"Horton has done a superb job bringing down debt levels while at the same time growing the business and positioning itself for the future," says Wedbush's McCaless. Horton now controls over 500,000 lots—enough for more than five years of building at 2022's expected pace.

Its shares, at a recent \$103, trade for about seven times the current earnings consensus of \$14.22 a share for the company's fiscal year ending in September. The shares yield 1%.

Kim of Evercore ISI sees earnings of about \$18 a share, arguing that Horton's gross margins, now about 27%, can hit 30%. He has an Outperform rating and a price target of \$163.

Lennar

The No. 2 home builder in terms of market value has done the best job among its peers of developing related businesses. These include multifamily and single-family rental housing ventures and investments like a stake in **Opendoor Technologies (OPEN)**, the online home buyer.

Lennar plans to spin off a group of noncore businesses, although it hasn't yet provided details. Shares, at about \$113, trade for 7.7 times projected 2022 earnings of almost \$15 a share.

Chairman Stuart Miller says that "the best of times" for home builders still have a way to go. "Since new-home construction cannot ramp quickly enough to fill the void of the production deficit that persisted over the past decade, short supply is likely to remain for some time to come," he said on the company's latest earnings conference call.

Investors can invest alongside Miller in the company's supervoting B shares, which trade at \$92, a big discount to the more-liquid Class A shares.

GoodHaven's Pitkowsky also favors the B shares, and they are probably the best way for retail investors

"The supply shortage built up over 10 years, and it won't go away quickly."

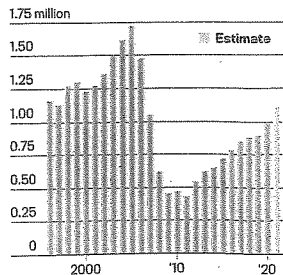
Stephen Kim, a housing analyst at Evercore ISI



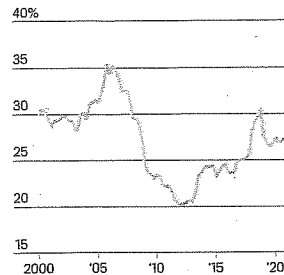
Room to Grow

Single-family housing starts have yet to catch up with the pace of building earlier this century. Housing affordability, meanwhile, remains favorable, with the median mortgage payment as a percentage of household income at about 30%.

Single-Family housing Starts



Mortgage Payment / After-Tax Household Income Ratio



Sources: Census Bureau; Evercore ISI; National Association of Realtors; Federal Home Loan Mortgage Corp.

to play Lennar, given the possibility that the share classes combine.

Toll Brothers

With its luxury focus, Toll is the most differentiated of the major home builders, and its competitive position is probably the strongest, since it competes primarily with smaller private builders.

Unlike the other big home builders, Toll Brothers focuses on the high end of the market, like its Travisso master-planned community in Leander, Texas, above, now being built.

Toll shares, at about \$68, trade for 7.6 times projected earnings of \$9 a share in the company's fiscal year ending in October 2022.

"The higher end of the market has seen the biggest reversal of fortune—in a good way," says Kim, noting weakness before the pandemic. Toll is benefiting from a larger prepandemic land

position than peers. He has an Outperform rating and a price target of \$86.

Higher-income white-collar workers—Toll's core customer base—tend to have more work-from-home flexibility, and that is translating into strong demand, with the average buyer spending \$160,000 on extras like home offices and multigenerational suites. And with longer construction periods than peers on its homes that can stretch a year or more, Toll's earnings gains could play out deep into 2022.

The company has developed what it calls "affordable luxury" homes in less expensive markets like South Carolina, with homes that sell on average for about \$740,000 and make up about 40% of its business.

PulteGroup

The No. 3 U.S. home builder caters mainly to first-time and move-up buyers. Through its Del Webb and DiVosta brands, it builds "active adult" communities catering to those near, and in, retirement.

Its shares, at about \$52, are among the cheapest of its large-cap peers at under six times projected 2022 earnings.

As more of a build-to-order company than D.R. Horton and Lennar, Pulte's earnings have more upside

potential, since its current closings reflect older orders. And sales prices on new orders were up 26% year over year in the third quarter, pointing to higher 2022 earnings.

The company has one of the best balance sheets among its peers, with minimal net debt. J.P. Morgan's Rehaut is bullish on the company, citing its financial strength and a return on equity of more than 25%. He has a price target of \$71.

Century Communities

Since going public seven years ago, the Colorado home builder has expanded to 17 states and becomes the country's ninth-largest builder.

The bulk of Century's sales go to entry-level buyers. Its Century Complete brand offers low-price homes with no options—the average selling price is just \$207,000—around smaller cities like Jacksonville, Fla., and Louisville, Ky.

"Century is leveraging its buying power to enter smaller markets where it can build homes to be competitive with the local resale market," says Wedbush's McCanless.

Shares, at about \$72, trade for five times projected 2022 earnings of about \$15 a share. McCanless has an Outperform rating and a \$110 price target on the stock.

Meritage Homes

The high-growth Arizona-based builder is focused on the entry-level market in the Southeast and Southwest U.S., with an average selling price of about \$400,000.

"We're in the affordable part of the market," Philippe Lord, Meritage's CEO, tells *Barron's*. "Our part of the market will be more resilient" if interest rates rise, he says, adding that Meritage homes offer higher quality and better design than other entry-level rivals.

Meritage, whose shares trade for about \$118, is expected to generate nearly 75% growth in earnings this year to \$19 a share, and a 21% gain in 2022 to \$23 a share. The stock trades for just five times projected 2022 earnings.

After its third-quarter results, the company "executed extremely well," despite materials shortages, Kim said. He has an Outperform rating and a price target of \$190 a share.

U.S. home builders have never been in better shape. Even after a strong 2021, their stocks could be poised for many years of gains. ■

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