Homebuilders

Lower rates likely a tailwind to 2024 ROE and margins; Raise POs

Price Objective Change

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Raise POs on homebuilders; lower rates = '24 ROE tailwind

Homebuilder valuations have increased sharply in the last two months with the 100bps decline in 10-year treasury since October 19. We think the recent re-rating is justified (and could continue). Homebuilders have navigated multiple mortgage rate spikes in the last 18 months while maintaining healthy margins and disciplined capital allocation. We raise our POs for homebuilder stocks by an average of 13% to reflect greater confidence in above-average ROE through 2024 and roll forward of price-to-book ratios to year-end 2024:

1) **Lower rates will help sales or margin or both**. Homebuilders have effectively used mortgage rate buydowns to offset the affordability headwinds. As mortgage rates decline, we expect some improvement in orders, but even more potential benefit to margins as homebuilders reduce incentives. We estimate a 50bps drop in rate buydowns equates to roughly 200bps benefit to builder gross margin (all else equal). This is an important offset as builders continue to face an inflationary backdrop in land, lot development and labor.

2) **New home prices/incentives already stabilized earlier this year,** and, in some cases, prices are rising again. For example, TOL increased prices in its communities in October as even as mortgage rates hit 8%.

3) **Supply chain continues to improve**. Build cycles on deliveries are still declining, which will support inventory turns (and ROE) into 2024.

We think incremental demand offsets additional supply

Homebuilder stocks have outperformed over the last two years despite higher mortgage rates partially because higher rates constrained supply more than demand. Lower rates will bring an increase in housing supply, but we believe the incremental demand created by improving affordability for current renters (>3mm renters that make >$150k/year) will absorb the increase in supply. NAHB estimates that every 25bps of mortgage rate decline from 7% "prices in" >1mm households. We still expect resale inventory to remain depressed if mortgage rates do not break <6% given the financial dis-incentive to move with average effective mortgage rate of ~3.5% (see Introducing the BofA US New Home and Existing Home Sales Indicators 21 November 2023. However, even if resale listings rise, the sellers often become buyers (potentially with a lot of cash).

Valuations still only slightly above historical average

The S&P Composite 1500 Homebuilding Index increased 70% vs. S&P 500 up 23% year-to-date. Still, price-to-book valuation for the group is slightly above the historical average (1.7X ex-NVR vs. long-term average of 1.6X) with above-average ROE in 2024. Builders will go into 2024 with historically strong balance sheets and capital allocation through 2024 will likely determine where ROEs fall in 2025/2026. Our top picks are TOL (most attractive valuation relative to ROE outlook in 2024) and PHM (expect re-rate as excess cash returned to shareholders). We raise our 2023E/2024E earnings for DFH and LEN based on improved demand trends and cycle times, as well as a lower interest rate outlook. See Lennar F4Q23 earnings preview below.

Exhibit 1: Homebuilder PO changes

POs increasing 13% on average

Home Builders	New PO	Old PO
DHI	$166	$150
LEN	$150	$133
PHM	$110	$92
TOL	$110	$103
KBH	$60	$53
NVR	$7,500	$6,400
DFH	$29	$27

Source: BofA Global Research

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ROE = return on equity

NAHB = National Association of Home Builders

Refer to important disclosures on page 9 to 12. Analyst Certification on page 8. Price Objective Basis/Risk on page 6.

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