Homebuilders

Fundamental backdrop still solid despite rate spike; Expect TOL to beat F3Q

Estimate Change

22 August 2023

Equity
United States
Homebuilders

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Higher rates weighing on homebuilder stock sentiment

Homebuilder stocks have underperformed the broader market over the last week (homebuilders down around 7% on an equal weight basis vs. S&P 500 down 2%). For context, the recent pullback puts the S&P Composite 1500 Homebuilding Index up 54% year-to-date vs. a 6% increase in S&P 1500. The sudden reaction of homebuilder stocks to mortgage rates that have been grinding higher over the last month caught some investors (and us) by surprise. We believe the pullback was driven by a combination of factors including: 1) recent spike in 10-year treasury yields and mortgage rates reaching the highest levels in 20+ years, including breaking above the 7% level, 2) potential for additional hawkish comments by Fed officials at the Jackson Hole conference later this week (which was a negative catalyst for the sector a year ago), 3) less attractive valuation and positioning following the strong sector performance year-to-date, 4) unfavorable seasonality in historical trading patterns and home demand, and 5) technical headwinds (see: Technicals meet Fundamentals: Building products 17 August 2023.

Fundamental backdrop still favorable

The recent spike in mortgage rates could weigh on sentiment near-term, but we continue to believe the fundamental backdrop from public builders remains favorable supported by: 1) existing home supply remains historically tight 2) new home demand appears resilient (in-line with normal seasonality) despite the rise in mortgage rate as homebuilders continue to effectively use mortgage rate buydowns to offset some of the affordability challenges, 3) Public homebuilders are taking market share from private builders and 4) Supply chain is gradually improving, which is a potential tailwind to margins and asset turns into 2024. Valuations have increased year-to-date but are still near the median of the historical average (1.4X ex-NVR vs. long-term average of 1.6X) with above-average return-on-equity and healthy balance sheets.

TOL preview: raise estimates for deliveries and GM

Toll Brothers (ticker: TOL) is scheduled to report F3Q23 earnings (ended July) after the market close on Tuesday, August 22 and will host its conference call on Wednesday, August 23 at 8:30am EST. Like other builders over the past two months, we expect TOL to beat consensus estimates on higher deliveries (improving supply chains) and gross margins (better pricing / lower incentives). We model F3Q EPS of $3.06 (vs. consensus of $2.86). We raise our 2023/2024E EPS estimates for TOL by 5%/9% driven by higher deliveries and gross margin. We expect net orders of roughly 2,200 homes in F3Q23, which is slightly better than normal seasonality. Our channel checks and industry data suggest May/June was better than normal seasonality and July was slightly below. Our key focus for the conference call will be the gross margin outlook in F4Q and F2024 and capital allocation going forward (underwriting land at current valuations compared to buying back stock). We reiterate Buy on TOL given its attractive valuation.

Refer to important disclosures on page 6 to 9. Analyst Certification on page 5. Price Objective Basis/Risk on page 5.
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Timestamp: 22 August 2023 03:26AM EDT

Key changes

Exhibit 2: BofA estimates vs. consensus
We are raising our TOL 2023 EPS estimate by 5% and 2024 by 9%

Homebuilders	New CY 2023E	Old CY 2023E	Consensus CY 2023E	New vs. Old	New vs. Consensus	New CY 2024E	Old CY 2024E	Consensus CY 2024E	New vs. Old	New vs. Consensus
TOL	10.81	10.29	10.65	5%	1%	10.19	9.37	9.94	9%	2%

Source: Bloomberg, BofA Global Research estimates

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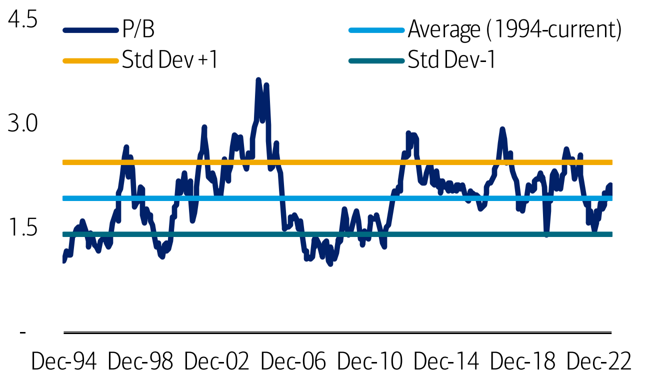
Valuations slightly below historical levels

Homebuilder stocks (equal weight) have increased 59% vs. S&P 500 up 14% year-to-date. Price-to-book valuation for the group is slightly below the historical average (1.4X ex-NVR vs. long-term average of 1.6X) with above-average return-on-equity and very healthy balance sheets (net cash).

Exhibit 2: Historical homebuilder price-to-forward book
Homebuilders are trading in-line with their long-term average



Source: Bloomberg
Data through Aug 21,2023; Includes DHI, KBH, LEN, PHM, TOL and NVR

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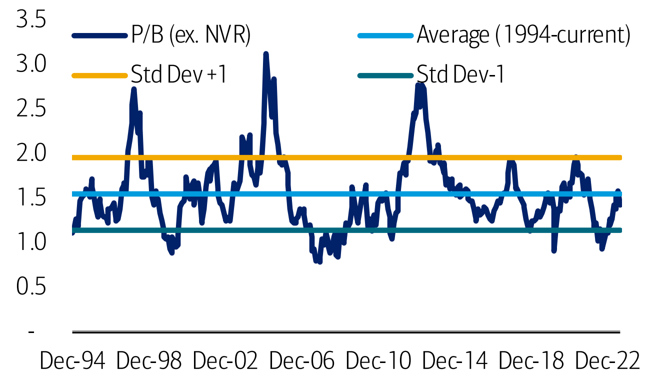
Exhibit 3: Historical homebuilder price-to-forward book (ex. NVR)
Homebuilders are trading at a discount to their long-term average (ex. NVR)



Source: Bloomberg
Data through Aug 21,2023; Includes DHI, KBH, LEN, PHM, and TOL

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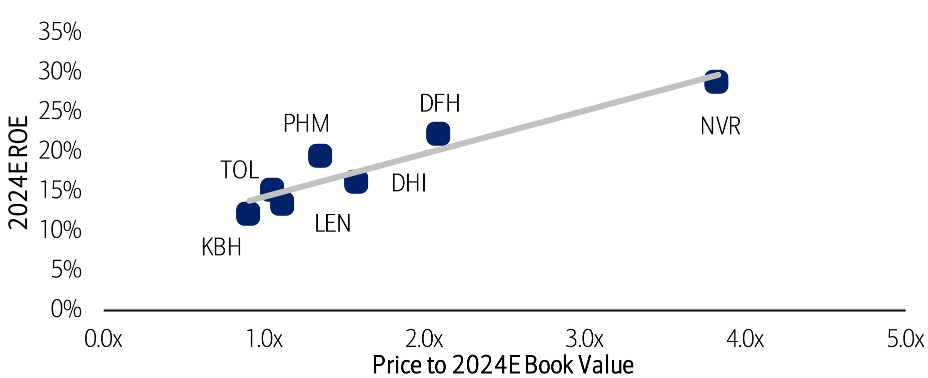
Exhibit 4: 2024 ROE vs. 2024E book value
Homebuilders are now trading above our estimates for 2024 book value



Source: Bloomberg, BofA Global Research estimates

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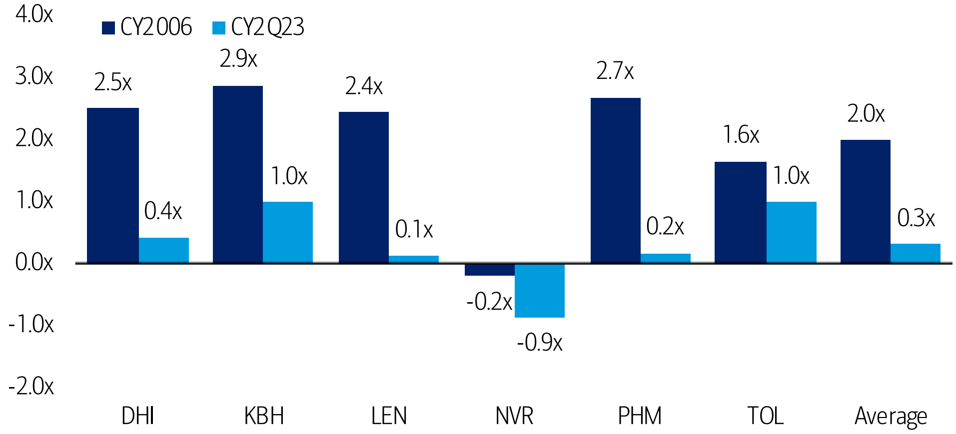
Exhibit 5: Homebuilder Net debt to adjusted EBITDA
Leverage ratios are well below pre-GFC levels



Source: Company reports

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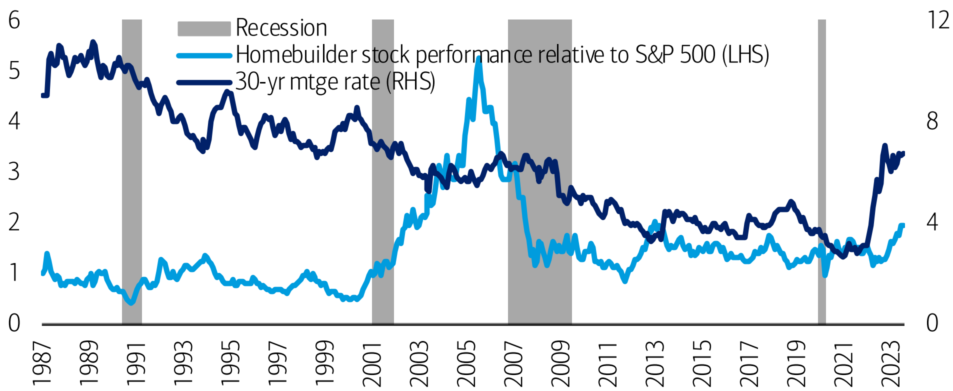
Higher mortgage rates pressuring homebuilder stocks

Homebuilder stocks have come under pressure over the last week as rising interest rates and lower affordability weigh on sentiment. The 30-year mortgage rate recently reached its highest level in the last 20+ years and the affordability index is at all-time lows. Despite the recent uptick in rates, we remain positive on the outlook for homebuilders, as demand remains positive with a shortage in housing supply and lower existing home inventory.

Exhibit 6: Homebuilder relative performance vs. 30-year mortgage rate
Homebuilders tend to underperform in a rising rate environment



Source: Bloomberg
Note: Data through July 2023

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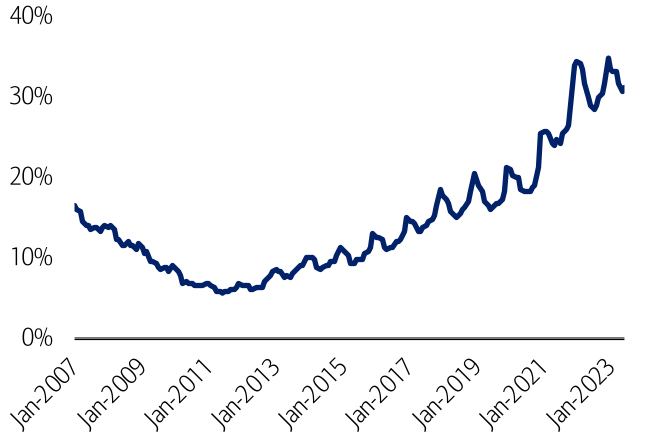
Existing home supply remains historically tight (nearly 50% below historical average) partially due to lock-in effect of higher mortgage rates. New home inventory is current ~30% of all available listings compared to the historical trend of 10-15%.

Exhibit 7: New home inventory as a % of total inventory
New home inventory was 31% of total inventory in June 2023



Source: Census Bureau, National Association of Realtors
Note: Data through June 2023
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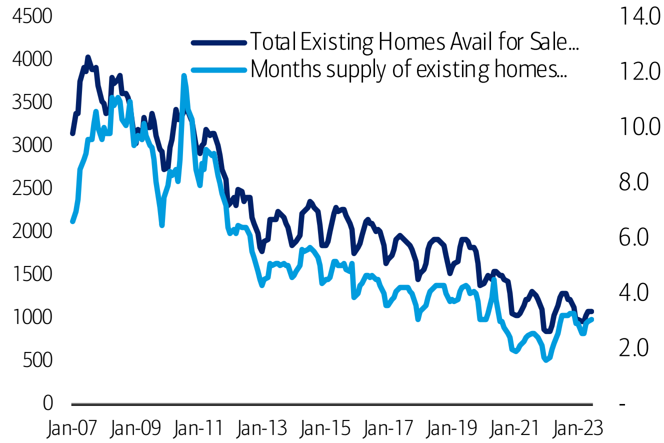
Exhibit 8: Existing home inventory
Existing home inventory continues to decline



Source: National Association of Realtors
Note: Data through June 2023
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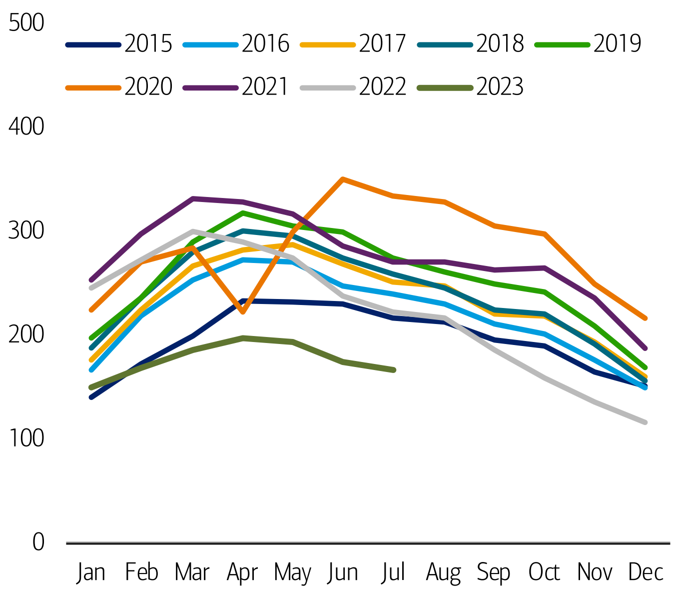
Recent demand appears resilient despite the rise in mortgage rates as homebuilders have effectively used mortgage rate buydowns to drive traffic and offset some the affordability headwinds for homebuyers. If interest rates continue to rise, we would expect homebuilders to further increase incentives or reduce price, which would weigh on gross margin.

Exhibit 9: MBA mortgage application purchase index
Mortgage applications remain depressed



Source: Mortgage Bankers Association
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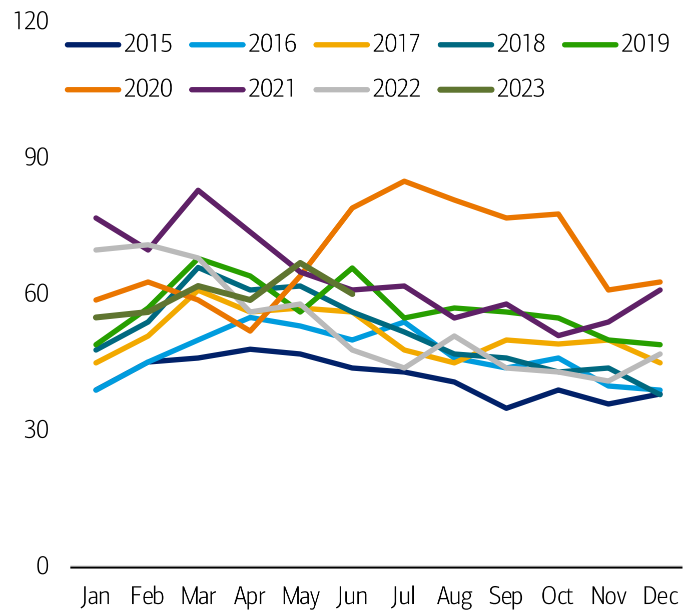
Exhibit 10: New single-family homes sales (NSA, thousands)
New single-family home sales are at similar levels to 2019



Source: Census Bureau
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Price objective basis & risk

Toll Brothers, Inc. (TOL, B-1-7, $75.05)

Our $88 PO on TOL shares is based on a price to forward 12-month book value multiple of roughly 1.4x, a slight discount to TOL's historical multiple (1.5x price to book value), which we view as appropriate given increasing affordability concerns and difficult comparisons.

Downside risks: (1) Luxury home demand could suffer an outsized decline during economic slowdowns, (2) Mid-Atlantic and Northeastern markets tend to grow more slowly, (3) potential earnings volatility given historically lumpy City Living sales, although this segment is now a small portion of TOL's overall business, (4) worsening affordability from rising rates, (5) supply chain issues and (6) slowing US economic growth.

Upside risks: (1) Luxury home demand could benefit by an outsized amount during economic strengthening, (2) Mid-Atlantic and Northeastern markets could grow more quickly, (3) improved lending markets could positively impact potential TOL customers needing to sell an existing home.

Analyst Certification

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	Latham Group, Inc.	SWIM	SWIM US	Shaun Calnan, CFA
	NVR, Inc.	NVR	NVR US	Rafe Jadrosich
	Owens Corning	OC	OC US	Rafe Jadrosich
	PulteGroup Inc.	PHM	PHM US	Rafe Jadrosich
	The AZEK Company Inc.	AZEK	AZEK US	Rafe Jadrosich
	Toll Brothers, Inc.	TOL	TOL US	Rafe Jadrosich
	TopBuild Corp	BLD	BLD US	Rafe Jadrosich
	Trex Company, Inc.	TREX	TREX US	Rafe Jadrosich
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	Patrick Industries, Inc.	PATK	PATK US	Rafe Jadrosich
	Pool Corporation	POOL	POOL US	Shaun Calnan, CFA

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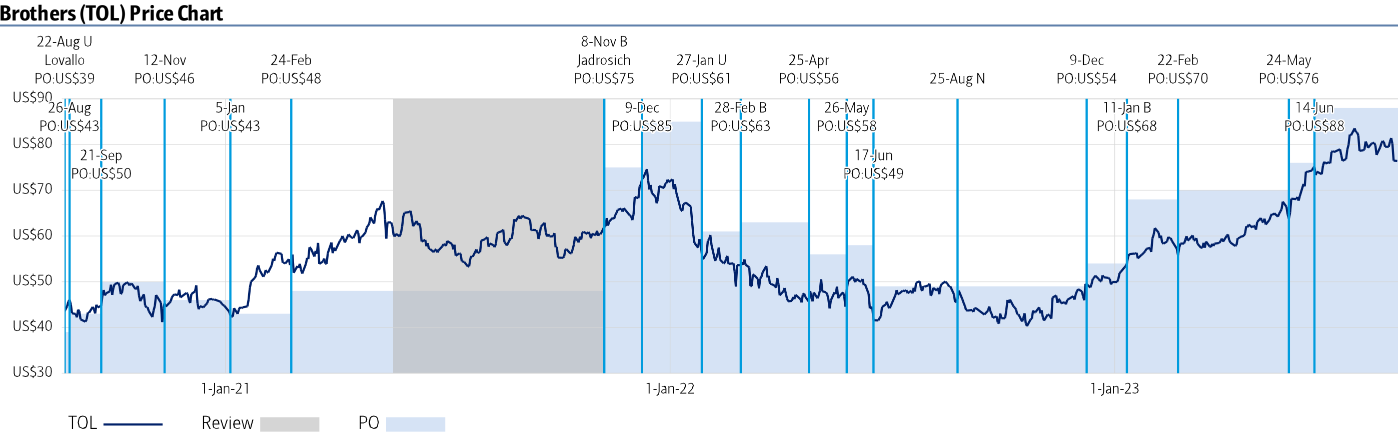
Toll Brothers (TOL) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	39	46.43%	Buy	23	58.97%
Hold	16	19.05%	Hold	9	56.25%
Sell	29	34.52%	Sell	9	31.03%

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Hold	815	23.13%	Hold	464	56.93%
Sell	831	23.59%	Sell	385	46.33%

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2]Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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