Homebuilders

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

Price Objective Change

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Equity
United States
Homebuilders

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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

Lennar F4Q preview

Expect focus on December trends, capital allocation

Lennar is scheduled to report F4Q23 (ended November) earnings on Thursday, December 14 after the market close and host its earnings conference call at 11am ET on Friday, December 15. We model 2Q EPS of $4.63 at the high-end of guidance of $4.40 - $4.70 driven by deliveries another beat on deliveries. We expect LEN to report 4Q orders of 16.8K (vs. guidance of 16-17k) and guide to roughly 17K orders (normal seasonality + low-single digit QoQ community count). We expect Lennar to guide to a 150-200bps sequential decline in gross margin in F1Q due to seasonality but expect margins to improve through the F1Q and into F2Q as the cost of rate buydowns falls with lower rates. We believe Lennar will initiate full year guidance for roughly 10% delivery growth. We expect investors to focus on: 1) December-to-date trends, 2) potential margin tailwinds from lower rates, and 3) level of share repurchase (we think investors expect a meaningful step-up in F2024 vs. F2023), and 4) updates to non-homebuilding segments including Quarterra.

Key changes

We are raising our POs for most of the homebuilders and we roll our target multiples to 2024 book value. We are also slightly raising price-to-book valuation due to lower interest rates. Our target price-to-book ratios are generally in-line with historical averages based on each homebuilder's ROE outlook. Our top picks are Toll Brothers (most attractive valuation relative to ROE outlook in 2024) and PulteGroup (expect re-rate higher as excess cash is returned to shareholders). We also reiterate our Buy rating on NVR and DHI given strong ROE outlooks relative to valuation. We reiterate Neutral on LEN/KBH given their lower ROE outlook relative to other builders. We also reiterate Neutral on DFH given its stronger ROE is already reflected in its premium valuation, in our view.

Exhibit 2: Price objective and multiple changes
We are raising POs by an average of 13%

Home Builders	New Rating	Old Rating	New PO	Old PO	New Multiple (P/2024E BV)	Old Multiple (P/12-mo fwd BV)	2024E ROE
DFH	Neutral	Neutral	$29	$27	2.5	2.5	24.2%
DHI	Buy	Buy	$166	$150	2.1	2.0	16.6%
KBH	Neutral	Neutral	$60	$53	1.1	1.0	13.6%
LEN	Neutral	Neutral	$150	$133	1.6	1.5	14.5%
NVR	Buy	Buy	$7,500	$6,400	5.5	5.0	31.7%
PHM	Buy	Buy	$110	$92	2.0	1.7	19.4%
TOL	Buy	Buy	$110	$103	1.5	1.4	17.4%

Source: BofA Global Research estimates
Note: DFH and LEN target multiples based on price to tangible book

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We raise our 2023E/2024E earnings forecast for DFH (+12% in 2023E & +15% in 2024E) and LEN (+6% in 2023E & +10% in 2024E), based on improved demand trends and cycle times, as well as a lower interest rate outlook.

Exhibit 3: BofA estimate changes
We are raising our 2024 EPS estimates for DFH and LEN by 15% and 10%, respectively

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
DFH	2.55	2.29	2.46	12%	4%	2.88	2.50	2.74	15%	5%
LEN	13.54	12.78	13.58	6%	0%	14.85	13.53	14.45	10%	3%

Source: Bloomberg, BofA Global Research estimates

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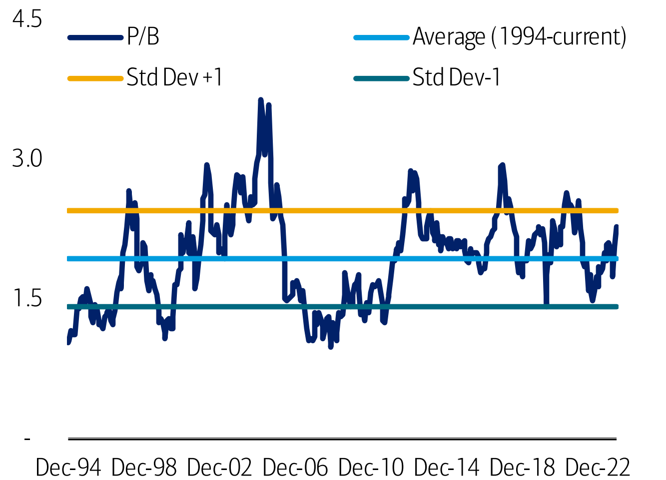
Valuations slightly above historical levels

The S&P Composite 1500 Homebuilding Index increased 70% vs. S&P 500 up 23% year-to-date. 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 return-on-equity and very healthy balance sheets (net cash).

Exhibit 4: Historical homebuilder price-to-forward book
Homebuilders are trading in-line with their long-term average



Source: Bloomberg
Data through Dec 13, 2023; Includes DHI, KBH, LEN, PHM, TOL and NVR

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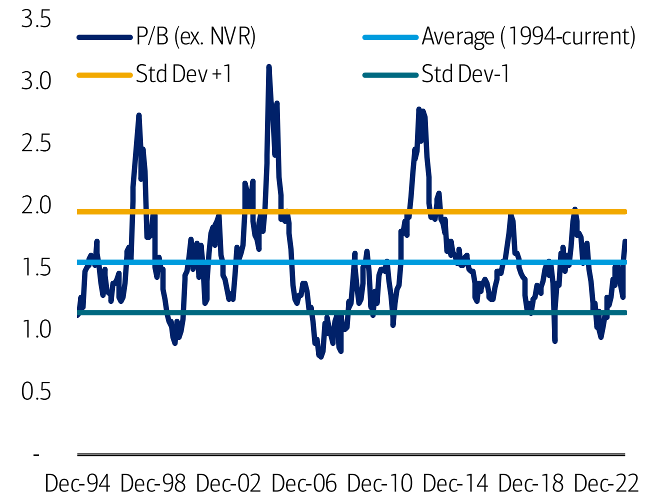
Exhibit 5: Historical homebuilder price-to-forward book (ex. NVR)
Homebuilders are trading at a discount to their long-term average (ex. NVR)



Source: Bloomberg
Data through Dec 13, 2023; Includes DHI, KBH, LEN, PHM, and TOL

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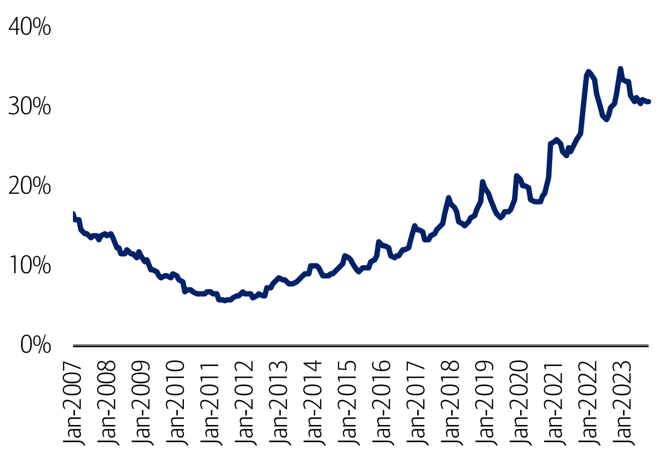
Existing home supply remains historically tight (nearly 50% below historical average) partially due to lock-in effect of higher mortgage rates. New home inventory is current 31% of all available listings compared to the historical trend of 10-15%.

Exhibit 6: New home inventory as a % of total inventory
New home inventory was 31% of total inventory in October 2023



Source: Census Bureau, National Association of Realtors
Note: Data through October 2023

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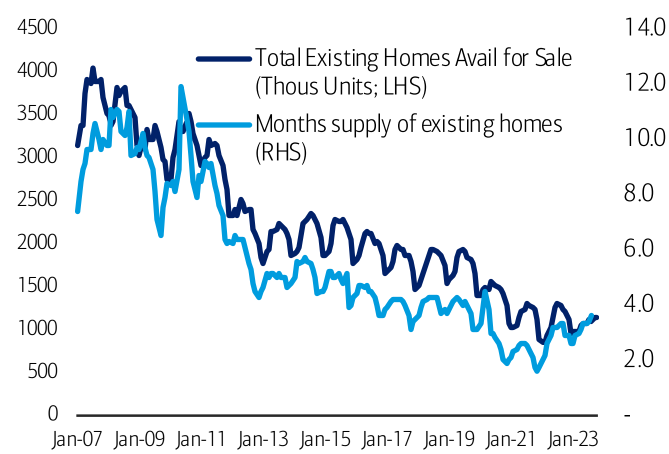
Exhibit 7: Existing home inventory
Existing home inventory remains at depressed levels



Source: National Association of Realtors
Note: Data through October 2023

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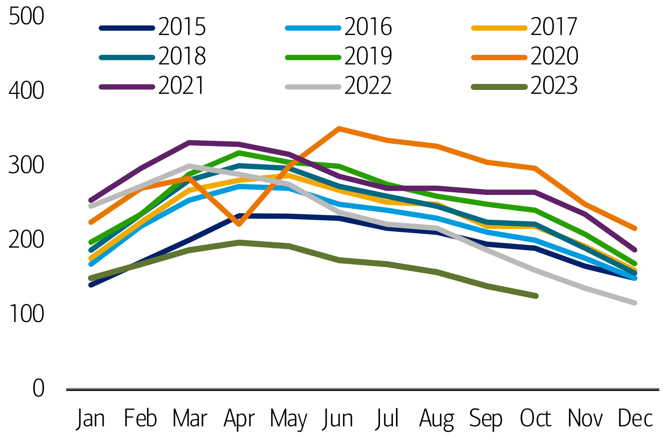
Recent demand has been relatively steady despite elevated mortgage rates as homebuilders have effectively used mortgage rate buydowns to drive traffic and offset some the affordability headwinds for homebuyers. New home sales appear to be returning to normal seasonal patterns, but the recent decline in rates has builder's optimistic about the spring selling season.

Exhibit 8: MBA mortgage application purchase index
Mortgage applications continue to decline to new lows



Source: Mortgage Bankers Association

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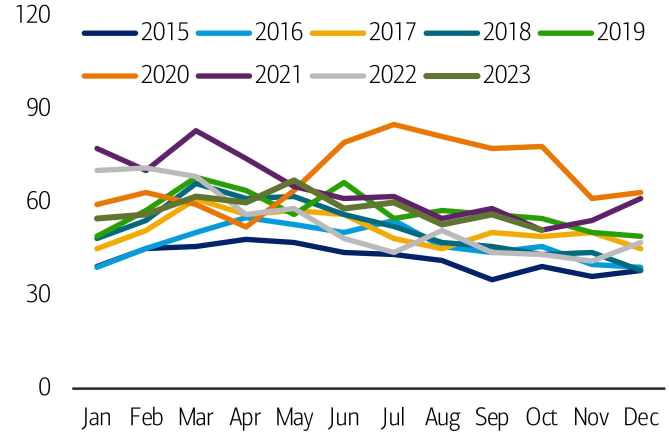
Exhibit 9: New single-family homes sales (NSA, thousands)
New single-family home sales are at similar levels to 2019



Source: Census Bureau

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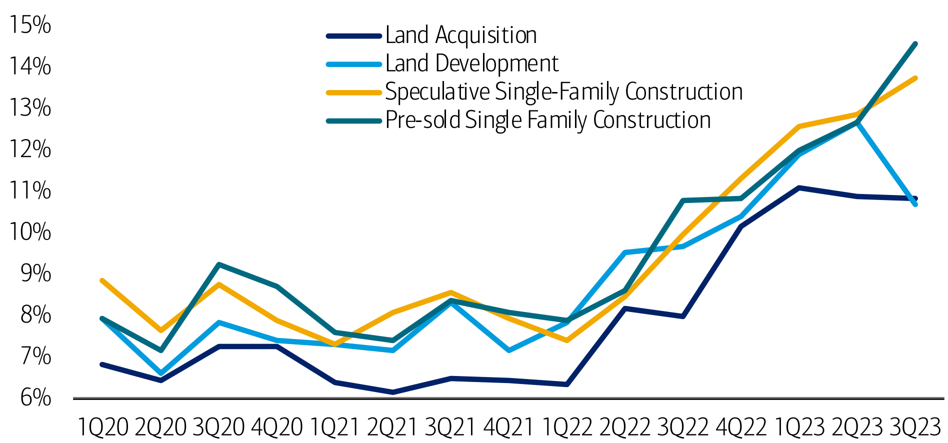
New home prices/incentives have stabilized, and, in some cases, pricing are increasing in the strongest markets.

Public homebuilders are well positioned to take market share from private builders that face significant soft cost headwinds from a spike in construction loan financing costs. Public builders have deep land pipelines.

Exhibit 10: Effective Interest Rate on Loans
The EIR for single-family construction continues to increase, while EIR on land purchases/development appear to have peaked



Source: National Association of Home Builders AD&C Survey, N = 146

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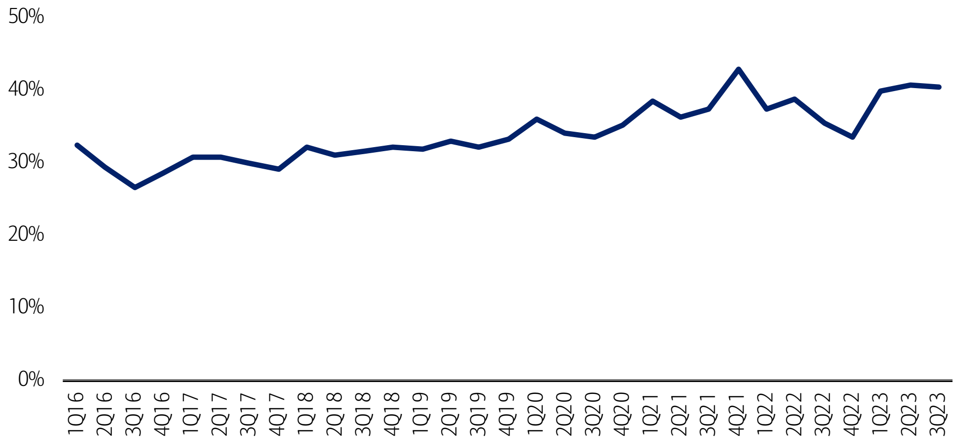
Exhibit 11: Major public homebuilder net orders as a % of new home sales
Public homebuilders share in 3Q23 was 500bps higher than in 3Q22



Source: Company Data, US Census Bureau
Homebuilders include: DHI, LEN, TOL, PHM, NVR, KBH, MTH, MDC, TMHC, CCS, LGIH, DFH
Note: New home sales are reported on a gross basis, while public builders report orders on a net basis, so in periods of high cancellations (similar to 3Q22/4Q22) our analysis understates the public builder market share relative to the industry.

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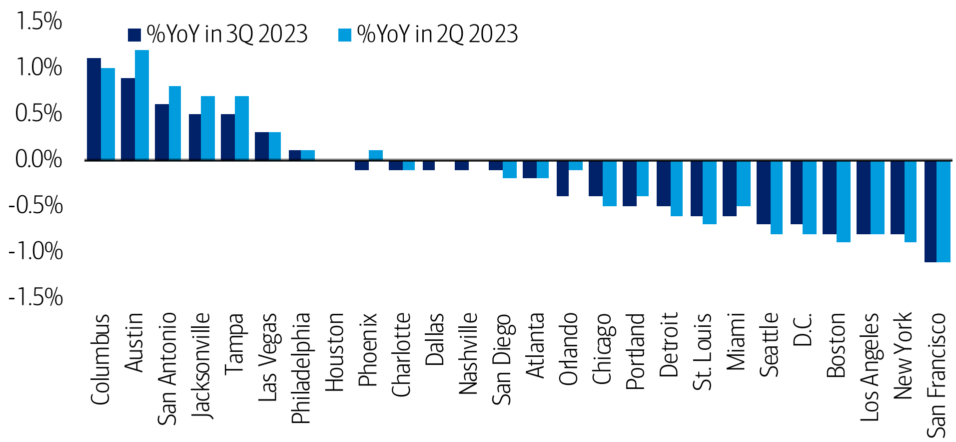
Migration to Texas/Florida has continued into 2023 (although at a slower pace than 2022).

Exhibit 12: Net population change in major MSAs, according to Bank of America internal data (year-over-year percentage change in 2Q and 3Q 2023, positive means net inflow, negative means net outflow, ranked by 3Q%YoY change)
Migration to Texas and Florida remains strong



Source: Bank of America Institute

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Exhibit 13: Stocks mentioned
Rating and price summary

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
DHI	DHI US	D.R. Horton	US$ 144.17	B-1-7

Exhibit 13: Stocks mentioned
Rating and price summary

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
DFH	DFH US	Dream Finders Homes	US$ 27.68	C-2-9
KBH	KBH US	KB Home	US$ 57.88	B-2-7
LEN	LEN US	Lennar Corporation	US$ 145.16	B-2-7
NVR	NVR US	NVR, Inc.	US$ 6684.86	B-1-9
PHM	PHM US	PulteGroup Inc.	US$ 97.96	B-1-7
TOL	TOL US	Toll Brothers	US$ 96.46	B-1-7

Source: BofA Global Research

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Price objective basis & risk

D.R. Horton, Inc. (DHI)

Our PO of $166 is based on 2.1x price to CY2024E book value, a slight premium to DHI's historical multiple. We believe a premium P/B compared to DHI's historical multiple is warranted given DHI's shift to a more asset-light model. On an absolute basis, this multiple is slightly above DHI's long-term average of 1.7x.

Downside risks: (1) Rising affordability concerns, (2) a sustained spike in interest rates, (3) supply chain issues limiting production, (4) macro headwinds affecting first-time buyers, (5) a speculative building strategy could result in discounting if demand is softer than expected, (6) a large and sustained increase in raw material costs, (7) potential unwillingness to return value to shareholders through increased dividends and share repurchase, and (8) a slowing US economy.

Dream Finders Homes, Inc. (DFH)

Our Dream Finders Homes PO is $29. We use price-to-tangible book to value Dream Finders given the challenges of forecasting earnings for high growth homebuilder. Our PO is based on 2.5X price to 2024E tangible book value, which is a premium to the current peer group average of 1.7X (ex. NVR) due to DFH's higher growth outlook compared to public peers and higher ROE.

Downside risks: (1) margins could decline if DFH is outbid by larger competitors for land, labor and materials, (2) supply chain bottlenecks, (3) affordability challenges from surging home price appreciation and interest rates ticking up from current levels and (4) slowing US economic growth.

Upside risks: (1) strong housing fundamentals continue to support demand, (2) continued net migration to markets where DFH has a presence, (3) ability to continue to improve margin and return metrics, 4) a potential easing in home price appreciation and/or pullback in interest rates.

KB Home (KBH)

Our PO of $60 is based on 1.1x price to 2024E book value, which is a discount to KBH's multiple during the most recent late cycle period in housing (1996 - 2003). We are using a discount multiple to reflect concerns about worsening affordability, industry-wide supply chain headwinds and tough comparisons.

Upside risks: 1) Better than expected gross margins, 2) Faster than anticipated improvement in ROE, 3) De-leveraging through debt paydown, 4) Better than expected pricing power, 5) Better than expected SG&A leverage.

Downside risks: 1) Cost pressures weighing on gross margins, 2) Slower than anticipated improvement in ROE, 3) An inability to de-lever with debt paydown, 4) Softer than expected pricing power, 5) Worse than expected SG&A leverage, 6) Slowing US economy.

Lennar Corporation (LEN)
Our PO of $150 is based on 1.6x price to 2024E tangible book value, slight premium to LEN's historical average (1.4-1.5x price to tangible book value) given favorable demand trends.

Downside risks: 1) worsening affordability, 2) expectations for rising rates, 3) continued supply chain challenges, 4) capital allocation less shareholder-friendly than some peers, 5) executing ancillary business strategy, 6) elevated mgmt. ownership, 7) higher financial leverage than some peers, 8) rising land prices and input costs, 8) potential for local permitting delays, and 9) slowing US economy.

Upside risks: 1) continued improvement in the US homebuilding market, 2) favorable interest rates and moderating home price appreciation, 3) potential for a more shareholder friendly approach to capital allocation, 4) better than expected execution of its rental business.

NVR, Inc. (NVR)
Our $7,500 PO is based on 5.5x 2024E book value, a significant premium to peers (1.4x), but roughly in line with NVR's historical average.

Downside risks: (1) worse-than-expected demand in core markets, (2) a decline in finished lot availability, leading to gross margin pressure and declining return on equity, (3) less stock liquidity than certain peers, (4) a continued increase in interest rates leading to affordability challenges, (5) significant increase in land, labor or material costs, (6) continued supply chain challenges, (7) slowing US economic growth

Upside risks: (1) better-than-expected demand in core markets, (2) an increase in finished lot availability, leading to gross margin acceleration and an increasing return on equity, (3) increased stock liquidity, (4) pullback in interest rates, key input costs or home price appreciation.

PulteGroup Inc. (PHM)
Our $110 PO on PHM shares is based on a 2024E book value multiple of roughly 2.0x, a slight premium to other builders in our coverage given PHM's higher ROE profile.

Downside risks: (1) worse than expected order growth, (2) failure to execute on PHM's efficiency strategy which could pressure margins and hurt ROE, (3) failure to capture first time buyers, (4) rising interest rates, (5) rising input costs, (6) labor tightness in certain markets, (7) slowing US economic growth

Upside risks: (1) better than expected order growth, (2) ability to execute on PHM's efficiency strategy which could raise margins and ROE, (3) increased traffic from first time buyers, (4) lower interest rates, (5) accommodative interest rates.

Toll Brothers, Inc. (TOL)
Our $110 PO on TOL shares is based on a price to 2024E book value multiple of roughly 1.5x, in line with TOL's historical average.

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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Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
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	D.R. Horton, Inc.	DHI	DHI US	Rafe Jadrosich
	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
NEUTRAL				
	Builders FirstSource Inc	BLDR	BLDR US	Rafe Jadrosich
	Dream Finders Homes, Inc.	DFH	DFH US	Rafe Jadrosich
	KB Home	KBH	KBH US	Rafe Jadrosich
	Lennar Corporation	LEN	LEN US	Rafe Jadrosich
UNDERPERFORM				
	Fortune Brands Innovations Inc	FBIN	FBIN US	Rafe Jadrosich
	Hayward Holdings, Inc.	HAYW	HAYW US	Rafe Jadrosich
	Masco Corp	MAS	MAS US	Rafe Jadrosich
	Mohawk Industries	MHK	MHK US	Rafe Jadrosich
	Patrick Industries, Inc.	PATK	PATK US	Rafe Jadrosich
	Pool Corporation	POOL	POOL US	Shaun Calnan, CFA

Disclosures

Important Disclosures

Equity Investment Rating Distribution: Building Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	41	47.67%	Buy	23	56.10%
Hold	14	16.28%	Hold	8	57.14%
Sell	31	36.05%	Sell	9	29.03%

Equity Investment Rating Distribution: Global Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	1869	53.48%	Buy	1046	55.97%
Hold	828	23.69%	Hold	461	55.68%
Sell	798	22.83%	Sell	370	46.37%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
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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