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PulteGroup Inc (PHM) CEO Ryan Marshall on Q3 2019 Results Earnings Call - Transcript

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Q3: 10-22-19 Earnings Summary

Press Release SEC *10-Q* *Slides*

EPS of $1.01 beats by $0.09 | Revenue of $2.71B (2.30% Y/Y) beats by $127.46M

Earning Call Audio

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PulteGroup Inc (NYSE:PHM) Q3 2019 Results Earnings Conference Call October 22, 2019 8:30 AM ET

Company Participants

Jim Zeumer - Vice President, Investor Relations and Corporate Communications

Ryan Marshall - President and Chief Executive Officer

Bob O'Shaughnessy - Executive Vice President and Chief Financial Officer

Conference Call Participants

Carl Reichardt - BTIG

Stephen Kim - Evercore

Matthew Bouley - Barclays

John Lovallo - Bank of America

Mike Dahl - RBC

Alan Ratner - Zelman & Associates

Ken Zener - KeyBanc

Rohit Seth - SunTrust

Maggie Wellborn - JPMorgan

Truman Patterson - Wells Fargo

Jack Micenko - SIG

Jay McCanless - Wedbush

Mark Weintraub - Seaport Global

Buck Horne - Raymond James

Alex Barron - Housing Research

Operator

Ladies and gentleman, thank you for standing by and welcome to the Q3 2019 PulteGroup, Inc. Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator instructions].

I will now turn the call over to your speaker today Jim Zeumer, Vice President of Corporate Communication and Investor Relations. Please go ahead.

Jim Zeumer

Thanks Julie. And good morning to everyone joining today's call to review PulteGroup's operating and financial results for our third quarter ended September 30, 2019. Joining on today's call are Ryan Marshall, President and CEO; Bob O'Shaughnessy, Executive Vice President and CFO; Jim Ossowski, Senior Vice President, Finance. For those who may have not seen a copy of our Q2 earnings release, it has been posted to our corporate website pultegroup.com along with a copy of the presentation slides that accompany this morning call. An audio replay of this call will also be posted to our website later today.

I want to highlight that as part of today's call we will be discussing our reported results as well as our results adjusted to exclude the impact of a warranty charge taken in the period. A reconciliation of our adjusted results to our reported results is included in this morning's release and within the webcast slides accompanying our call this morning. We encourage you to review these tables to assist in your analysis of our results. I also want to alert all participants that today's discussion will include forward-looking statements about expected future performance of PulteGroup.

Actual results could differ materially from those suggested by comments made today. The most significant risk factors that could affect our results are summarized as part of today's earnings release and within the accompanying presentation slides. These risk factors and other key information are detailed in our SEC filings, including our annual and quarterly reports.

Now, let me turn the call over to Ryan Marshall. Ryan?

Ryan Marshall

Thanks Jim and good morning. I'm excited to speak with you today about PulteGroup's outstanding third quarter results. In addition to discussing our financial performance I'm pleased to report that home buying activity remained strong and even accelerated in the third quarter. Benefiting from the positive demand environment and our strong local market positions, I would highlight that our third quarter orders increased 13% over last year and we reported our highest third quarter order volume since 2006. For the past several years, U.S. housing demand has been supported by an ongoing economic expansion, low unemployment and positive consumer confidence numbers.

It will come as no surprise however, when I say that the catalyst for this most recent rise in housing demand has likely been the decline in interest rates and its impact on the affordability equation. In housing market where years of price appreciation has created affordability challenges for many buyers, the decline in rates has helped to ease the problem. Given this improvement in affordability, we are optimistic about the sustainability of housing demand and the potential for new home sales to continue marching higher.

As Bob will detail, PulteGroup reported strong third quarter operating and financial results that met or exceeded our prior guidance in a number of key areas. Within our quarterly results, you can also see continuing progress against some of our broader operating strategies.

First, we continue to realize success in expanding our presence among first-time buyers as orders increased 39%. Broadly defined, our business objective is to better index our customer mix to the markets we serve with the goal of growing first-time to about one-third of our closings. In this most recent quarter first-time buyers represented 31% of orders and 29% of closings. This is up from 25% of orders and 26% of closings last year. Consistent with this objective, 34% of our lots under control in the third quarter are targeted to serve first-time buyers. Given this mix and the development timelines of our lots in our pipeline, we expect to see an ongoing modest expansion of our first-time business as we progress through 2020 and beyond.

Second, in addition to making progress in shifting the mix of lots we control, we continue to increase our use of lot options to help enhance returns and mitigate certain market risks. We ended the quarter with 161,000 lots under control, of which 42% were held via option. Our target is for 50% of PulteGroup's lots under control to be held via option. Consistent with this goal, I would highlight that 68% of the lots we approved for purchase during the first nine months of 2019 included some form of option. I can't recall a year when we were as successful in securing so many option transactions.

Our local land acquisition teams are doing a great job of tying up lots under such option structures. This includes the American West transaction where we put 3,500 lots under control, two-thirds of which are under option.

And finally, consistent with our long-term focus on effectively allocating capital in support of generating higher returns, we invested approximately $700 million in the business in Q3, while returning a $166 million to shareholders through dividends, and share repurchases. In total, we have returned almost $340 million to shareholders in the first nine months of the year, while still ending Q3 with $769 million in cash, and a net debt to capital ratio of 27.6%. By intelligently investing in our business and running an efficient homebuilding operation, while effectively allocating the available capital, we continue to generate some of the highest returns in the industry.

For the past 12 months, our return on invested capital was approximately 18%, while our return on equity was almost 19%. PulteGroup continues to rank among the industry leaders on both return metrics.

In conclusion, we remain highly constructive on current demand dynamics and the long-term opportunities for the housing cycle, as well as our competitive position within the markets we serve. At 644,000 new home sales over the trailing 12 months, we believe the industry continues to undersupply the country's housing needs. With strong market positions, tremendous financial flexibility, and an unwavering commitment to our homebuyers, we believe PulteGroup can grow its operations while continuing to generate higher returns on our invested capital and equity.

Now, let me turn the call to Bob for a more detailed review of the quarter.

Bob O'Shaughnessy

Thanks, Ryan, and good morning everyone. As highlighted in this morning's release, we reported an acceleration in sales activity as PulteGroup's third quarter orders increased 13% over last year to 6,031 homes. Orders were higher across all buyer groups and reporting segments, and the 13% increase in quarterly new orders is the largest percentage increase we've generated since the end of 2017.

Analyzing Q3 sales by buyer group shows orders among first-time buyers were up 39% to 1,860 homes, while orders among move-up and active adult buyers both increased by 4% to 2,579 and 1,592 homes respectively.

During the third quarter, we operated out of 865 communities which is up 4% over last year. Adjusting for the 4% increase in community count, our absorption pace for the quarter was up a strong 9%. The increased absorption pace was driven by a 22%

increase from our first-time communities and an 8% increase from our move-up communities.

Absorption pace in active adult was down 9% against a strong third quarter comp that was up approximately 10% last year.

Moving to our income statement, home sale revenues for the third quarter increased 3% over the past year to $2.6 billion. Our higher revenues were driven by a 3% increase in closings to 6,186 homes as our average sales price of $426,000 this year is consistent with last year.

Given the stronger demand conditions we experienced in the quarter, we were able to sell and close more spec homes, which had a positive impact on our Q3 closing volumes.

Looking at our average sales prices in more detail, our move-up and active adult prices both increased 3% to $491,000 and $411,000 respectively. Pricing for our first-time homes decreased 6% to $340,000. The lower ASP within the first-time reflects a change in mix relating to our efforts to increase our entry level exposure, particularly through community openings in the Southeast, Florida and Texas.

In total, and consistent with our efforts to better index our business to market demand and increase our first-time buyer business, closings by buyer group in the third quarter were 29% first-time, 45% move-up and 26% active adult. This compares to the 26% first-time, 49% move-up and 25% active adult last year.

Our backlog at the end of the third quarter totaled 11,638 homes which is up 4% over last year. We ended the quarter with 11,482 homes under construction, which is an increase of 2%. Of the homes under production, 74% or 8,529 were sold with the remaining 26% being built as spec. At 26%, spec production is consistent with last year and in line with our target range.

Based on our contract backlog and the units we had under construction at the end of the quarter, we expect deliveries in the fourth quarter to be in the range of 6,600 to 6,800 homes. Inclusive of this guidance, we are increasing guidance for the full-year closings to be in the range of 23,000 to 23,200 homes. With a backlog ASP of $430,000 and a relatively stable pricing environment we continue to expect our average sales price of closings in the fourth quarter to be in the range of $425,000 to $430,000. This is consistent with our third quarter results and the guidance we gave on our second quarter earnings call.

Continuing down the income statement, our reported gross margin in the third quarter was 23.1%, while our adjusted gross margin for the period was 23.4%. The adjusted gross margin excludes the $9 million pre-tax charge related to estimated costs to complete warranty repairs in a closed-out community. Our adjusted gross margin was up 30 basis points from our second quarter reported gross margin of 23.1% as we benefited from a stronger demand environment, but was down 60 basis points compared to the third quarter of last year as profitability was impacted by higher land, labor and material costs and slight changes in product mix.

In the third quarter, our option revenues and lot premiums increased 1% over the prior year to $82,966 per home. Sales discounts in the quarter totaled 3.8% or $17,000 per home which is up 80 basis points over the third quarter of last year but down 10 points sequentially. Discounts are now down 20 basis points from the beginning of the year.

While demand dynamics are clearly better, we are being careful in our pricing actions as we believe affordability though improved is still an issue within particular markets and buyer segments. With that being said, we do see the opportunity through cost controls and select pricing actions to continue to generating higher gross margins. We currently expect our fourth quarter gross margin to be in the range of 23.2% to 23.4%.

Our SG&A in the third quarter was $271 million or 10.3% of home sale revenues, which is in line with our previous guidance. Prior year SG&A expense for the period was $253 million or 9.8% of home sale revenues. The increase in SG&A dollars was driven by a number of factors including IT spend, operating costs associated with the American West transaction, increased model home costs and compensation. Based on our performance of the first nine months of the year, we reiterate our guide for full-year SG&A to be in the range of 10.8% to 11.3% of home sale revenues.

In the quarter our financial services operations generated pre-tax income of $32 million, which is an increase of 64% over the third quarter of last year. Our performance was driven by higher volumes as the businesses benefited from our increased homebuilding volumes and higher capture rates, as well as from improved margins in our mortgage operations due to the favorable interest rate environment. In total, our mortgage capture rate in the third quarter increased to 84% from 75% last year.

Our income tax expense for the third quarter was $93 million, or an effective tax rate of 25.4%, which compares with $95 million or an effective tax rate of 24.7% last year. We currently expect our fourth quarter tax rate to be 25.3%, which is in line with previous guidance.

Reported net income for our third quarter was $273 million or $0.99 per share, while our adjusted net income for the period was $280 million or $1.01 per share. Reported net income for the third quarter of last year was $290 million or $1.01 per share. Our diluted earnings per share was calculated using 274 million shares, which is a decrease of 11 million shares or approximately 4% from Q3 of last year. Decrease in share count is due primarily to the company's ongoing share repurchase activities.

In the third quarter, the company repurchased 4.1 million common shares for $136 million or an average price of $32.93 per share. During the first nine months of 2019 we repurchased 7.7 million shares of stock for $244 million, or an average cost of $31.86 per share.

As Ryan noted, we ended the quarter with $769 million of cash and a net debt to capital ratio of 27.6%. Our gross debt to capital ratio at the end of the quarter was 34.6%.

Looking at our land activities during the quarter, we invested a total of $693 million in land acquisition related development. This brings our nine month land spend total this year, including the American West transaction in April to $2.2 billion. We continue to expect to spend approximately $2.9 billion on land in 2019.

Finally, at the end of the third quarter, we controlled approximately 161,000 lots, of which 42% were held via option.

Now, let me turn the call over to Ryan for some final comments on market conditions. Ryan?

Ryan Marshall

Thanks, Bob. Before opening the call to questions, let me provide a quick review of our market performance in the quarter. In addition to our orders being up 13% over last year, we realized order gains across all geographic reporting segments and buyer groups, which attested the broad base strength in buyer interest. Drilling down a little, we realized generally good demand up and down the Eastern third of the country with particular strength in the Carolinas and Florida. Florida continued to be a standout with strong demand across each of its key markets. Looking at the middle of the country, Texas continued to experience strong demand across its markets with orders up 10%. Demand in the Midwest held up as orders increased 9%, but the move-up part of the business in these markets remains very competitive. And while the GM strike appears to be on track to be settled, we did see an impact on demand in many of our Midwest markets, resulting from the lengthy labor dispute.

Driven by the strength of Las Vegas, including our American West acquisition and Arizona, our West area continued to improve. During the first few weeks of October, buyer interest remains strong as we've seen continued high levels of buyer interest and overall demand. With supportive economic conditions and a low interest rate environment, we look for buyers to remain active right through the end of 2019.

Let me close by thanking all of our employees who have done such an outstanding job this year serving our customers and each other. Thanks to your hard work. We continue to be an industry leader operationally, financially and most importantly with the quality of home and experience we deliver to our customers. We have also recently been certified as the Best Places to Work Company by the Best Places to Work Organization. In an environment where the competition for talent is fierce, we see being an employer of choice is a tremendous advantage.

I will now turn the call back to Jim.

Jim Zeumer

Hey. Thanks, Ryan. Julie, if you open the lines we will start our Q&A.

Question-and-Answer Session

Operator

[Operator instructions]. Your first question comes from the line of Carl Reichardt with BTIG. Your line is now open.

Carl Reichardt

I have -- your last comment Ryan, I was curious about the idea that expecting buyers to remain active through the end of 2019, are you seeing in October and do you expect to see sort of an anti-seasonal strength in traffic and how is your spec situation holdup to be able to maybe turn some of those late coming in orders into deliveries this year?

Ryan Marshall

Yes, Carl, we've continued to see nice strength from the buyers as we've been through the first three weeks of October. It's been continued strength similar to what we saw throughout the third quarter. So I feel very good about that. In terms of bucking the seasonal trend, I think it's hard to kind of buck the normal things that are going on in lives and holidays and things of that nature, but certainly the improved affordability environment that we're in I think has got to play well for the entire industry and certainly us. As far as your question on specs Carl, probably less of a spec opportunity for us as we move into the fourth quarter relative to what we had in Q3 and Q2. That being said, we've got a few more spec units in the system right now than we did a year ago, but it's not meaningful to the overall number.

Carl Reichardt

Thank, Ryan. And then my follow up is just on lot options. You're running 42 now and you're hoping to get to 50. So are we to infer that you're starting to see an expansion of developers who are willing to do lots with you on an option basis or are there new structures coming or land bankers returning? And I'm just interested since many builders want to expand in that direction whether or not the infrastructure underneath the landside is going to allow for it. Thanks.

Ryan Marshall

Yes, Carl, it's been a concerted effort on our part to move in that direction. And we put -- if you go back about three years ago when you first started hearing me talk about this, we put a goal out there. We've I think been using wisdom and judgment in a way that we are able to secure option transactions. There is certainly a cost associated with those. And so I think we've continued to make good economic decisions that make sense for our business and where we use and where we don't.

We're not using land bankers widely throughout the systems, so most of these options are truly with the land seller. I think our reputation, our performance, the brands that we bring to the table certainly help make the offering if you will in doing business with us a compelling one and we're going to continue to try and drive that number closer to the 50% target that we've set.

Operator

Your next question comes from the line of Stephen Kim from Evercore.

Stephen Kim

I just wanted to follow up if I could on Carl's last question there about land spend. Obviously, given all things being equal, any builder, including yourself would probably rather push a little bit of the risk onto the land seller. So it always comes down to terms and pricing. And so you addressed the fact that you're not using land bankers widely. But you acknowledged that there is an additional cost. And so I was curious if you could also broaden that into the financial terms. How are the terms trending? Are you putting more down for instance, or are there certain sort -- certain types of work that you're committing to do? If you could just sort of talk a little bit about whatever change in terms is happening that's allowing you to make the shift to greater options, while still retaining the judgment?

And then second part of that question is, you gave a goal for the ratio of options. But for modeling, it might be more useful if we actually had a target for actual year supply of land owned, rather than just the ratio of option to total?

Bob O'Shaughnessy

Yes, Stephen, to the second one, we've been, I think pretty clear that our goal would be to have three years owned, three years optioned. So that's our target as our teams are out building and negotiating the land transactions that we're looking at individual transactions. And if we're getting out, it depends on markets. We've got points of view on length in different markets too. But on balance, we'd like the book to be roughly three years owned, three years optioned.

In terms of terms, really no significant change, and I think it's really the way we're approaching it. So, rather than sort of a blanket to the field, bout, shout, do something, whether it's two years owned or a certain amount of optionality, these are individually negotiated. That's why I think you've seen a fairly measured increase in this over time. We've not seen a push or a need to put more money down. We don't see significant offsites or performance guarantees. So, I would tell you that the options today look a lot like the options we've been working into the system for the last few years. But it's the reason you can't -- you don't see us go from 40% to 60% overnight. It's because we're negotiating deal by deal.

Stephen Kim

Thanks for that, Bob. I guess second question I had relates to the commentary you had made about rates. Ryan, you had indicated that rates were obviously a benefit to you throughout the quarter and you anticipated that rates would likely stay relatively low. And therefore that would help demand through the end of the year. I just wanted to dig into that a little bit more. Is there a threshold you have in mind above which -- and I'm talking about a rate threshold -- above which your outlook would reasonably need to change? And could you talk a little bit about the delay that we saw and you saw, I think in terms of your demand response in your markets, even though rates have kind of been falling all year. If you can talk a little bit about the sensitivity, the lag perhaps, and if there is a threshold in mind above which your outlook would reasonably need to change?

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Ryan Marshall

Yes, Stephen, I did highlight rates because I think it was really the last leg of the stool in the affordability equation to come through. So, the way that we like to look at it, we've got rates, we've got home prices and we have wage changes. All three of those things and how they're working in unison, I believe contribute to that affordability equation. With a fairly benign pricing environment, we haven't seen a whole lot of price change, wages that are actually starting to meaningfully increase as well as the interest rates coming down to the level that they're currently at. In our view really improved affordability and I think that's what has really given demand a kick in the pants from the buyer side. So, we feel good about that. Our view that, that can be sustained through the end of the year, I think will continue to bode well for what new orders look like. As far as, is there a threshold? I don't think there is. I think it comes down to what does that affordability equation look like and can the average consumer afford the average new home price or the new home price. That's what I believe it really boils down to.

The last thing I'd just say maybe on interest rates whether they're going up or they're going down. I think it really matters why. And so what's the rest of the narrative that's going on in the overall economy and how that ultimately plays on the consumers well-being and their overall confidence in the economy.

Operator

Your next question comes from the line of Matthew Bouley from Barclays. Your line is open.

Matthew Bouley

So, looking at the sales pace, I believe you did 2.3 for the quarter seems to be a high for Pulte for the cycle. So I know, Ryan, you highlighted kind of the buyer sensitivity around just home prices in general in this market. But is there kind of any expectation at this point that perhaps you could meter that growth a bit and push price further at this stage or just conversely as you guys just keep mixing towards first-time buyers, is that not really the right way to think about it that really sales pace should kind of structurally move higher at this point? Thank you.

Ryan Marshall

Yes, Matthew. Thanks for the question. Good to hear from you. And I guess a couple of things that I would tell you. Number one, our focus has and will continue to be on driving return on invested capital. We don't underwrite the gross margin. And so we are on a community by community basis working the levers between pace and price to drive what we believe is the optimal return outcome. As far as our overall sales mix, certainly our per community sales pace has been helped by our gradual shift and more first-time business, entry level business, which tends to come with a higher per month sales average. And so I think you heard in our prepared remarks, you'll continue to see a little more of that over time, but as we near our target of about one-third of our closing volume coming from that buyer group.

Finally to your question on prices and is there an opportunity for it to go higher? Certainly, the market is strong, but affordability I think has got to continue to carry the day, and we're still kind of balancing right on the -- we're teetering on the edge of a lack of affordability. And so I think our hesitancy there would be to push it too far and break that affordability equation that seems to be working right now.

Matthew Bouley

Thanks for that detail. And then just secondly I wanted to follow-up on the gross margin side, I think the Q4 guidance is calling for somewhat flattish to perhaps slightly down gross margin sequentially. And I know Bob you just highlighted that sales discounts do continue to move lower a bit. So, just any other kind of puts and takes in there that might drive kind of that flatter trend in Q4? Thank you.

Bob O'Shaughnessy

Yes, fair question. I think it's always worth reminding everyone, we do have the highest margin mix in the builder space and we're protective of that, but you heard Ryan say we actually manage against return. We do have more expensive lands coming through each time. We sell a new house that the land coming behind will be a little bit more expensive. And on the pricing side, we do see some opportunities to raise price, but we always wanted to Ryan's point be mindful of overall availability and affordability. So, mix matters in that certainly as Q4 comes to fruition, you'll have a lot of builders out there working to liquidate their standing inventory and so we think that will impact pricing. So, as we look at the universe, we really like our margin position. But we want to make sure we're productive with our assets. We want to make sure our asset turns are efficient. So, we feel really good actually about the margin profile we're putting out for Q4.

Ryan Marshall

Matt, the only other thing I'd add to that is keep in mind given that we're mostly a to be built order model, a large part of what will deliver in Q4 is already in our backlog, and while we've got a few spec opportunities you know those any kind of improved pricing environment reduced discounts don't move the needle a ton at this point for Q4, but as Bob highlighted in his prepared remarks, we are seeing an improvement in the discounting environment, and I think that is reflective of the continued strength we've seen from buyer demand.

Operator

Your next question comes from the line of John Lovallo from Bank of America. Your line is open.

John Lovallo

The first question is, the strength in your first-time business was clearly encouraging, but there is some hesitation that seems to still kind of be lingering with active adult and maybe to a lesser extent on the move-up side. So, is there an opportunity to be a little bit more proactive perhaps with the incentives as we move into the fourth quarter here or are you comfortable with the current strategy?

Ryan Marshall

Hey, John. It's Ryan. Thanks for the question. We actually feel really good about our active adult business. We saw a 4% increase in new orders in the active adult business. I think what you're likely referring to is the decline in absorptions on a year-over-year basis we are down 9%. I think without getting into kind of too much detail Bob highlighted that it was up against a pretty stiff comp from last year that was up 10% at that point in time. As we looked at it, a couple of other things that I just highlight for you on the active adult side. We've got existing communities where we have added incremental product offerings into an already existing location. The way that we keep track of it and reported that count is an additional community. The absolute gross number of sales out of those locations is increased, but in some cases, it causes the per community number, it's dilutive to the per community number. The other thing that we think we've got going on inside of our active adult business as we move from some of our really large flagship communities and into our smaller faster turning kind of closer in locations. The per community sales out of those smaller locations tend to be a little bit lower.

Now the return profile is every bit is good, the margin profile is everybody is good, but the absolute level of upfront investment in some of these smaller communities is less. And so they don't need to generate the same type of monthly sales to make it work. Those are a few of the things that you know that we've done. And so I think I touched on all those things, John. I'm not sure if there's anything else that was missing there, but we can maybe get it in a follow-up, if I missed anything.

John Lovallo

Thank you, Ryan and then maybe just a quick update on American West and its contribution to orders in the quarter?

Ryan Marshall

Yes. We're really pleased with that. The orders in the quarter is 145 and the integration has gone really well. Sales activity is strong. We expect closings Q1 of next year.

Operator

Your next question comes from the line of Mike Dahl from RBC. Your line is open.

Mike Dahl

I've got a two follow-up questions on the pricing side. So, I think, Ryan you've clearly articulated the balanced approach, which makes sense given what we lived through over the past year. But just wanted to try to get a sense of, if you can provide just percentage of communities where you've been able to raise pricing either on, it would be great if you could break it down by base price versus where you've just lowered incentives, but any color you can give on just breadth of price increases?

Ryan Marshall

Yes, Mike, I don't have that level of detail here that I can provide on the call. Broadly, what I would tell you is that you saw an increase in average sales price in our move-up, you saw an increase in average sales price in the active adult. We saw an increase in our options spend and our lot premiums and we've seen a little bit of a decrease in discounting. So, there has been little bits and pieces kind of across the board. Our gross margin for the quarter was strong. We came in slightly above the guide that we provided. And so I think while we're being cautious. We have seen a favorable pricing environment that's been beneficial to the overall profitability of the business.

Mike Dahl

Second question and a follow-on specifically related to specs. You highlighted that as being a contributor to some of the upside around the closings in the quarter and to your point on margins, it doesn't seem like it's coming out a real drag to margins. Do you have the spread on spec versus margins for the quarter and how that compared to the prior two quarters?

Ryan Marshall

Yes, we try not to give all that much detail around that, Mike, I think what we've highlighted is that we did see some closing opportunity. If you recall, we came into the year with a little more spec than we thought. We've kind of worked through most of that. It came through in the closings in Q2 and Q3 largely. You saw a little bit of upside relative to our margin guide some of that is mix. Some of that is the spec contribution because it does have a higher than historical margin. So, typically, we would have expected the margin profile to be a little bit less than it was reflective of the demand environment. So, on balance, it was a good thing. Don't want to try and drill into that much detail here.

Operator

Your next question comes from the line of Alan Ratner from Zelman & Associates. Your line is open.

Alan Ratner

Hey guys, good morning. Nice quarter.

Ryan Marshall

Thanks, Alan.

Alan Ratner

So, first question, just going back to the option discussion for a second, if we could. So, first off, congrats on the progress there. I know in the past and you've kind of alluded to this, but understanding you underwrite to an ROIC calculation. Can you talk a little bit about what the margin spread on a typical option deal that you do versus a development deal looks like, and just kind of thinking about what that means to mix shift going forward. If we look at the percentage of your closings this quarter that were I guess originally option deals. How does that compare to the current 42% of your land book that's under option?

Bob O'Shaughnessy

Yes, to your second question, Alan, I don't know that on top of my head. We can do a little bit of homework for you. In terms of the forward book, I think, it varies honestly because these options all -- because we're doing them individually, they all have kind of different shapes and sizes. So, the size of the community matters, are we buying raw lots on option or finished lots on option. So, at the end of the day, for us it's just becomes part of the pipeline of land coming through. So, we don't actually analyze it or track it by wasn't an option or not is again the return is the thing we're focused on. I think like anything else if you're asking people to take a little more risk, there's a little more costs associated with that. And we see that obviously, but clearly some of the lots we're doing today were purchased on option two, three years ago. And yet with that we're still able to generate the returns and the margins we are.

Ryan Marshall

Yes, and to that point, Alan, I just add onto Bob's comment that we've been doing options for a long, long time. It's not like we were doing none and then we went to the 42% we sit at today. We just felt there was an opportunity to increase it closer to that 50%. So, you're certainly going to see a higher mix of option lot start to mix into the overall closings, but to do kind of the point Bob made it will be mixed into the overall business and we'll provide you kind of what the forward guide looks like as it speaks to the margin profile for future years when we get there.

Alan Ratner

Okay. Yes, I appreciate that, Ryan, and I just totally understand that you've been doing this for a while. That's why I want to just kind of attempt to quantify what that mix looks like understanding that it's always been a part of your business. Second question, Ryan, I know you've been obviously very focused on innovation within the sector both on the construction side as well as mortgage-related, consumer-related. So, I was just curious, if you can update us if there is anything you're seeing on the ground that you're particularly excited about or that the company is embarking on that might change the way you either build houses, sell houses anything along those lines?

Ryan Marshall

Yes, I think two things Alan there I would give a shout out to our financial services team. They have done just a wonderful job in innovating in the eyes of the consumer and making it easier to apply for and go through the mortgage process as they move throughout the cycle. And I think the results are evident in the 84% capture that we had in the current quarter. It's a win for our company and I think our customers are getting great satisfaction and high kind of overall net promoter scores and things of that nature by being with our internal mortgage company. So, Deb still who runs our financial services organization and her team. I think they just done a wonderful job in taking care of our customers. So, nice innovation there and we've got some neat things coming down the pipeline in the future that will continue to make it better. The second thing, Alan, that I'm really excited about is it relates to home building operations is the off-site manufacturing opportunities that continue to evolve. And there is great conversations there and we continue to have significant dialog and at the table with other partners and vendors and manufacturers that

I think can meaningfully change the way that we build houses in the future. We know labors getting more and more tight. And so the opportunity to get some efficiencies in the way that we produce will significantly help to solve some of the problems that I think are inherent in a shortage of labor. The last thing is the high buyers. We're seeing some nice things happening there that I think are helping us and helping the consumers reduce the amount of friction that's involved in marketing and selling home. So, the Opendoors, Offerpads, Knock et cetera, all of those companies are companies that we're working with as well.

Operator

Your next question comes from the line of Ken Zener from KeyBanc. Your line is open.

Ken Zener

SG&A, if you're giving 10.8 to 11.3 for the year, it's kind of implying up 4Q from 3Q consistent with last year. So I understand that. Could you just Bob go into a little detail why when you have higher revenue, your SG&A is going up, just so I can understand that?

Bob O'Shaughnessy

Yes, we talked about it, Ken, in our prepared remarks, and we had a couple of areas where we had some increased spend first is IT. There we are investing in the business. We've got several projects in our IT is -- our IT department has a lot going on and these are projects that will take candidly a number of years to finish. And so we're working through that. You also see American West we had highlighted that will continue. We've got spend. So, if you think about what we did, we bought the lots, but didn't buy the backlog, but we took the people, so they continue to sell and build homes. So, we've got overhead costs associated with that in the business that will continue in Q4 and we won't get the closings until next year. We do have more models with more communities open that will continue. So, really it's more of the same in Q4 as to what you saw in Q3. It's what we guided to. So, this is spend that we knew was coming and we've talked about that really the leverage will get out of the business over time will be volume-oriented. And so as the business grows, we think we can be more efficient, but really nothing in Q4 or Q3 that we didn't see coming.

Ken Zener

True, but I guess to the extent and you highlighted specific items this year. We saw that same trend last year. I mean, is that something just about how you kind of capitalize in terms of CapEx your business is my question?

Bob O'Shaughnessy

Not sure I followed, Ken.

Ken Zener

Last year you didn't get SG&A leverage either in the fourth quarter, even though you had more revenues. I am just seeing, if that's something particular to how you guys, right, pursue IT?

Ryan Marshall

Yes. Well, I think if you're looking at last year specifically, certainly compensation would have been a bigger part of the conversation because we've got annual plans and long-term plans and we had a pretty good year last year. And so that was reflected in that, but I don't think there's anything structural certainly last year over this year or last year and this year that would cause us to think that we're losing leverage. We'll dig into it though. We'll see if there's anything else there.

Operator

Your next question comes from the line of Rohit Seth from SunTrust. Your line is open.

Rohit Seth

Just with your comments on land spend and closing out of communities during the quarter, I mean, just hopefully can you share any thoughts on the direction of community count over the next six to 12 months?

Ryan Marshall

We haven't given any guide. Yes, we'll do that as we release our fourth quarter earnings in January.

Operator

Your next question comes from the line of Michael Rehaut from JPMorgan. Your line is open.

Maggie Wellborn

Hi. This is actually Maggie on for Mike. First, I wanted to ask about the cadence of orders throughout the quarter. Did you see strong demand across all three months or any months stronger than others?

Ryan Marshall

Maggie, all three months proved to be similarly strong relative to prior year. It was in a overall balanced quarter.

Maggie Wellborn

And second I wanted to ask about your West segment. You pointed the improvement this quarter driven by Vegas and Arizona. And last quarter you had mentioned that in California you were still seeing challenging conditions, but they kind of seem to be stabilizing, and you were beginning to see a return of buyers to your communities. So, I was wondering if you could give an update on what you saw in California this quarter?

Ryan Marshall

Yes, Southern California I would characterize is continuing to improve not completely out of the woods, but we're seeing some green shoots. And Northern California is a market that I think is still challenged by affordability in particular in the Bay Area, which is where most of our assets are concentrated that part of the country continues to be a little slow.

Operator

Your next question comes from the line of Truman Patterson from Wells Fargo. Your line is open.

Truman Patterson

Just wanted to talk about your first-time buyer strategy. It's now 34% of lots. It seems like you guys might let that drift higher going forward slightly. But how comfortable do you feel letting this segment get in size based on the current market conditions you guys had really robust demand there. And then maybe could you just elaborate a little bit on your strategy really to target that buyer from a product and land perspective?

Ryan Marshall

Yes, Truman, we obviously are very pleased with the results that we saw out of that first-time space and we're going to stay disciplined and kind of the way that we see the broader market through cycles. Certainly it's a consumer that's doing really well in the current cycle, but I don't know that we would want to wildly shift our focus completely to that side and lose sight of the other strong segments that we have in our business in the active adult and the move-up. So, we've intentionally kind of targeted at about a third of our business. The mix of lots that we have is right in line with that and you'll start to see that come through in our closing mix a little bit more each and every quarter. And so we continue to be very pleased. As far as how we're targeting that buyer, it really is about affordability. I think it's also about making the process easier. And so there is a few things that we're doing and simplifying the way that we market communicate and sell to that buyer and where we've got a number of kind of test projects that we're running in our Texas business and in some of our businesses in the West and we're excited about kind of what that holds for the future of our first-time and entry level business.

Truman Patterson

Jumping over to the labor environment hoping you guys can give us an update on that. What you're seeing very nice rebound in the housing market the past few quarters. Are you starting to see wage inflation accelerate or are you starting to see availability issues start to rear up that's causing lengthening construction cycles or anything like that?

Bob O'Shaughnessy

Truman, it's a great question. Interestingly, no, we haven't. To this point at any rate, the availability is there. Pricing is not aggressive. I think part of that has to do with the mix of homes that are being built. So, as you move down into this entry level lower optionality smaller floor plans especially for the folks that are building more spec those homes are a lot more efficient to build. And so I think you can move more through the system with the labor that we've got. And I think the entire industry is benefiting from that. So good news is at least to this point, knock on wood, it's been a pretty good environment. We had given a guide for our labor and material input cost to be up about 2% this year. We actually think that's closer to 1% now. Part of that is that the labor environment has been pretty attractive.

Operator

Your next question comes from the line of Jack Micenko from SIG. Your line is open.

Jack Micenko

I wanted to revisit Ken's question a little bit on the G&A side. I know you called out some one-timer. Is it fair for us then to assume some of those expenses this year or more temporary and we'll see incremental leverage going forward or Bob is your IT commentary suggests maybe this is more of a flat line on the ratio?

Bob O'Shaughnessy

Yes, certainly for the IT. What we do obviously as we've got some costs that are capitalized and when systems come online we actually depreciate them. That I think is a kind of an increase in cost. Others, if we've got expenses just associated with running the department, that's a period cost, so that can go up or down depending on the level of spend. We talked about American West, obviously, we'll get leverage on that, but we start to see closings beginning in January of next year. So, we haven't given the guide for next year. Once again we'll do that as part of our Q4 earnings release. But like I said I don't think there's anything structurally that makes us think that we're losing leverage in the business at all.

Ryan Marshall

Yes, Jack, and the only thing maybe just to pile on there is the leverage that we're seeing as well within the guide that we've provided. I think Bob's commentary about the increase over prior year and some of the things that he called out were to show the differential and total spend this year relative to last year.

Jack Micenko

Okay. And then on mortgage really nice results there. Looking back, I'm not sure you've done a better 3Q margin in that business and maybe ever. So, you've got the three legs, alright, you've got capture rate better, you've got more volume. But you've got to be doing something on the cost to originate side it looks like. Is that fair to assume and our margins in that business absent the first two sort of just inherently improving as you maybe invest in that business. Just curious what's driving these really good margins?

Ryan Marshall

Yes, it's sort of all of those things. If you think about the environment that the mortgage originators are operating in today, falling rates, a big refi business going on right now. So, the market is attractive and we're taking advantage of that. But -- and you raised a great point, we've actually reduced our cost to produce loans, which is every bit is impactful to our bottom-line and you talked about the third leg, obviously, a 9% increase in capture is a big volume generator for us. And so we've kind of hit on all three in this most recent quarter. The refi business might start to slow down. So, the rate environment might become a little bit more challenging as -- call in the next six, 12 months, but what we've got there is a really efficient team and one that's focused on customer satisfaction in order to drive that continued improved capture rate environment. So, the team is; A, taking advantage of the market that's there, but also getting better at what they do, which will be an annuity for us.

Operator

Your next question comes from the line of Jay McCanless from Wedbush. Your line is open.

Jay McCanless

The first question I had, what do you expect for community count for 4Q?

Bob O'Shaughnessy

The guide we've given, Jay, is 3% to 5% year-over-year same quarter. Same quarter to prior year same quarter.

Jay McCanless

And then the second question I had just trying to catch up with the share repurchase. What was the actual share count at quarter-end?

Bob O'Shaughnessy

The weighted average share count was 274 million, the outstanding shares is 271 million.

Jay McCanless

And then the last question I had was on active adult. Could you guys -- I know you've talked in the past about shifting to some of these smaller, faster turning communities. What would you say the percentage of total Del Webb or some of these newer generation communities versus the older larger communities?

Bob O'Shaughnessy

Well certainly in terms of the number of communities, the majority is the newer, smaller, faster turning. I'd have to do the math to see what percentage of the sign ups was or closings came out of those. But yeah there are not very many of those big bold, but I used to call the cruise ship Del Webb's left.

Operator

Your next question comes from the line of Mark Weintraub from Seaport Global. Your line is open.

Mark Weintraub

Two quick cleanup questions. One just on share repurchase. How price sensitive do you consider yourselves to be or is it you have cash flow to be put to good use and share repurchases and gets a percentage of that cash flow?

Ryan Marshall

Yes, it's interesting, I feel like a broken record with this one sometimes, but we've got a very clearly articulated capital allocation policy. First and foremost in the business, we want to pay our dividend through cycle, we obviously raised our dividend this year 20% then we've introduced debt. So, you saw some of our capital to buy in some of our near-dated debt in this year and that we would use excess capital to return to shareholders. Having said that, we're not stock pickers. So, we're not trying to time the market, but we do have a view on value. And so as we look over time and it really is over time. Today we have almost $70 million in cash, strong cash generation of the business, but we're looking over a three-year horizon in the business. And so I think you'll always see us active in the equity market. Our spend is influenced by; A, what are we going to put in the business and what do we think about that. Other possible uses of capital and to an extent the share price as well. So, we're not making that, we've got a process we go through with our board that is pretty thoughtful actually in terms of how we actually invest in the business and in our stock.

Mark Weintraub

And then just second given the questions on labor etc and you made the point on offsite manufacturing is something you're exploring. How soon might we start seeing more aggressive measures on offsite manufacturing? What type of timeline on those initiatives?

Bob O'Shaughnessy

Yes, Mark, it's something that I think we've said we'll take some time to play out. It's a business that I think will meaningfully change the landscape of home building over the next three to five years and even probably more over the five to 10-year cycle. So, we've really worked to simplify our business over the last 10 years, the number of floor plans that we have in our portfolio, how efficient they are to build. We've been preparing to move a significant chunk of our volume that is well designed and simplified into a factory significant chunk of our volume that is well designed and simplified into a factory environment. We're already using a high percentage of wall panels. About 60% of the homes that we frame in wood are already using pre-manufactured wall panels and pre-manufactured trusses. So it's -- look, I think, it's closer than you think and it's already starting to be embedded into our business, but I do believe that over the kind of medium-term you'll start to see even more changes to the industry and to our business for sure.

Operator

Your next question comes from the line of Buck Horne from Raymond James. Your line is open.

Buck Horne

I'll try to make this pretty quick. I think, Bob, you mentioned your labor and materials cost inflation was trending more towards 1% this year. Could you possibly break that apart in terms of the labor and material side in terms of how those trends, cost trends are faring. And just as we're looking ahead how do you -- how you guys planning for lumber costs with some of the mill shutdowns out there and do you think that could start to rise on you into 2020?

Bob O'Shaughnessy

Yes, we haven't sliced the onion that thin in terms of what percentage of the costs are doing what. But what we did highlight for you guys is that in the 2% guide of material input costs that it was against the backdrop where lumber was down. And so the increase was labor because most of the other input costs are pretty flat year-over-year. And so what that should be done is lumber has been what we expected and labor has come in a little bit. In terms of what do we think about the lumber market certainly the supply dynamics matter, the demand dynamics matter. We'll give you our view on what we think that means for 2020 when we release our earnings and by then I think we'll have a pretty good view into people's expectations for both of those supply and demand dynamics around lumber. And so we'll give you our view on how we think it's going to influence the business next year.

Buck Horne

And my second question just as demand and just overall fundamentals have improved. I'm wondering if the environment for M&A opportunities is evolved at all. And is there potentially interest in finding another partner like an American West if there is another market that a deal like that would exist is the appetite or the environment evolved on M&A possibilities?

Ryan Marshall

Yes, Buck, I would put M&A into the priority that Bob laid out. Our first priority in terms of capital allocation, which is to invest in the business and that's the category that we look at M&A in. For the most part when we're looking at M&A it is because we've got an interest in a market we're not in or there is a land pipeline that's available that will continue to help support our market position. American West certainly fit into that. We had a great Vegas operation. We've made it even stronger with the addition of American West. We've got an always-on appetite for M&A, but it needs to line up with where we're going strategically. Is it helping us with the amount of lots that we're looking to have and the way those lots are structured. Is it helping us with the consumer group? Is it helping us with a market? We're not interested in M&A just for volume sake is, I think, the key points that I'd want to share with you relates to M&A.

Operator

Your next question comes from the line of Alex Barron with Housing Research. Your line is open.

Alex Barron

I wanted to ask about your first-time buyer or entry-level segment. How does the margins there compared to the rest of the company. I've heard some company's comment that they are a little bit lower than move-up and some say that they are few hundred basis points higher. So, I'm just kind of curious where you guys stand?

Ryan Marshall

Yes, Alex, it's Ryan, we've got a nice margin profile in that business right now and it's largely because that's where the majority of the growth has been and it's where we've seen a lot of price appreciation. So, the margin profile is actually just a tad higher than our move-up right now. Historically speaking it's been the lower margin profile, but the inventory turns more than offset that, and you see a very similar return profile as you do in any of the other segments.

Alex Barron

And then can you remind me what percentage of the business it is today and where would you guys see that going in the next couple of years?

Ryan Marshall

It's 29% of our closings in the current quarter and we see it going to about a third of our business overall.

Alex Barron

And lastly, is there any reason why your interest expense wouldn't go down as a percentage of revenues next year. It doesn't seem like your current interest expense the same as your interest incurred. So, I'm just trying to reconcile those.

Bob O'Shaughnessy

Yes, it's a fair question. Obviously with the leverage that we took out of the business this year we see a lower cash cost. All of our interest gets capitalized and amortized over time. And so you'll see that influence over the next couple of years honestly. Our capitalized interest charge in our gross margin. So, all things being equal if revenue stays the same, you'll see it be a little bit of a tailwind in our margin over time.

Operator

And there are no further questions at this time. I will turn the call back over to the presenters for closing remarks.

Ryan Marshall

Ryan Marshall

Okay. Thanks, everybody for your time this morning. We'll certainly be available over the course of the day if you have any other questions and we'll look forward to talking to you on Q4.

Operator

This concludes today's conference call. You may now disconnect.