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OUTLOOK

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Homebuilding - US

Slower growth, increasing headwinds, prompt outlook cut to stable from positive

Our outlook for the US homebuilding industry is stable. This outlook reflects our expectations for the fundamental business conditions in the industry over the next 12 to 18 months.

» **We are lowering our outlook to stable, with macro factors and recent order trends pointing to slower growth ahead.** Our triggers for moving our outlook from positive to stable include industry average gross margins dipping below 20% and annual industry revenue growth falling below 10%. We now believe the latter is likely to occur in 2019.

» **Positive signals remain, but signs of a slowdown are increasing.** Many of the underlying drivers of the industry's health remain solid. For example, consumer confidence is near a 20-year high, and initial claims for unemployment recently hit a 49-year low. However, there are increasing signs of a slowdown. Three that are especially troublesome are steadily rising mortgage rates, declining affordability, and ballooning inventories.

» **We do not see a return to the robust order books of the last few years that produced superior revenue growth.** The current buyer softness may be temporary, given the currently strong underlying industry fundamentals. That said, we now believe that industry revenue growth in 2019 will be below 10%, in the 6%-8% range.

» **Two companies likely to exceed those revenue expectations are D.R. Horton Inc. (Baa3 stable) and Lennar Corporation (Ba1 stable).** The homebuilder most likely to be hurt by an industry slowdown is Hovnanian Enterprises Inc. (Caa1 stable).

**Since outlooks represent our forward-looking view on business conditions that factor into our ratings, a negative (positive) outlook suggests that negative (positive) rating actions are more likely on average. However, the industry outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of rating outlooks of issuers in the industry, but rather our assessment of the main direction of business fundamentals within the overall industry.*

Outlook changed to stable as growth slows, headwinds increase

We are changing our outlook to stable from positive, reflecting our belief that industry revenue growth will slow. The number and strength of headwinds hindering industry growth have increased in recent months. In addition to the three especially worrying signs – inexorably rising mortgage rates, declining affordability (see Exhibit 1, page 3), and swelling new home inventories (see Exhibit 2, page 3) – the industry is encountering slowing customer traffic and order rates. It is also continuing to confront labor constraints and volatile raw material prices, with the latter being exacerbated by new tariffs.

Additionally, some key macro factors are not helping. Budget deficits are expanding, despite robust economic growth and very low unemployment. This will boost government borrowing and possibly restrict economic growth as the cost of credit increases.

Both the overall economic expansion of 112 months and the homebuilding expansion of nearly seven years are getting quite long by historical standards and may be nearing the end of their expansion cycle. Meanwhile, geopolitical risks abound. Overseas, the EU is facing challenges such as Brexit, while trade tensions between the US and China may disrupt business and consumer confidence.

Numerous macro factors remain on solid footing

Consumer confidence (see Exhibit 3, page 4) is near a 20-year high while initial claims for unemployment were recently at a 49-year low. Wages and household real income growth (see Exhibit 4, page 4) are gaining traction, and employment and GDP are registering respectable to vigorous growth. Meanwhile, the aging of millennials is resulting in a growing group of millions reaching an age when they are forming families and buying homes.

Some important industry factors also remain supportive, including: robust backlogs, despite the slowing orders; low cancellation rates; and housing starts and new home sales still trending below long-term averages (see Exhibit 5, page 5). These all indicate that, even after seven years of homebuilding expansion, excess is largely absent in the industry.

Even the strong fundamentals will not produce revenue growth of the past

Despite the still-strong fundamentals, we do not foresee a return to the prior 10%-plus annual industry revenue growth and are now projecting industry revenue growth of 6%-8% in 2019 (see Exhibit 6, page 5). This is still a respectable growth rate by US corporate standards.

This will be comprised of 3%-5% unit volume growth, accompanied by approximately 1%-3% average price growth. We are also projecting weighted average industry gross margins to hover around 20%.

While industry revenue growth will slow, a few issuers will outperform

Even in this slowing environment, a few issuers will outperform. D.R. Horton (Baa3 stable) and Lennar Corporation (Ba1 stable) will, we believe, generate unit volume growth in the high single digits to the low double digits, with low single-digit price growth. Meanwhile, Hovnanian is likely to be the builder most adversely affected by an industry slowdown.

What could change our outlook

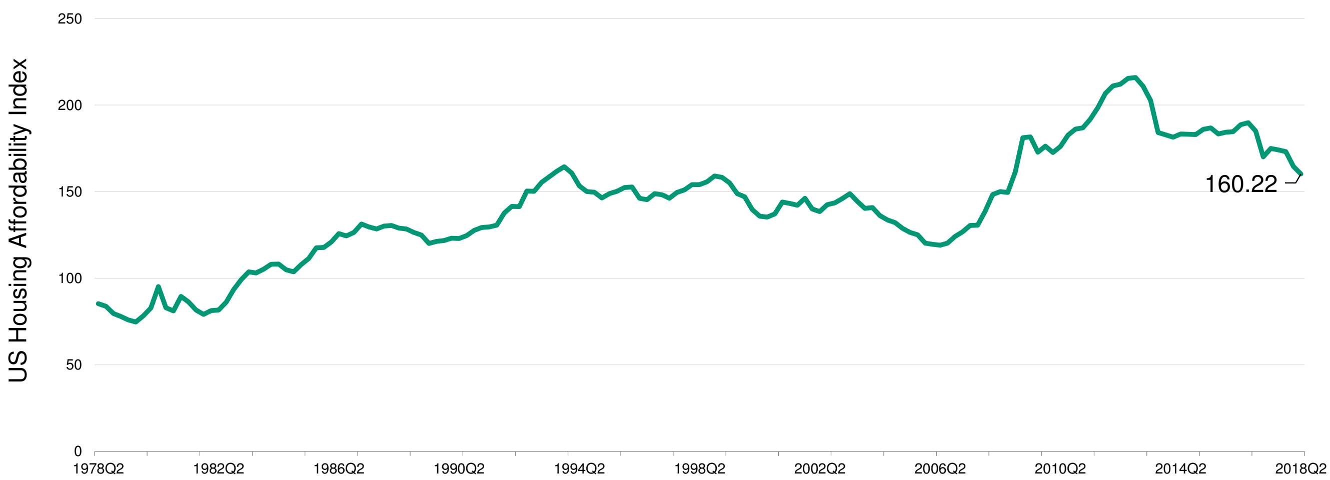
We could change our stable homebuilding industry outlook back to positive if industry revenue growth were again to accelerate beyond 10%, while average gross margins remained above 20%.

Alternatively, we could change our stable outlook to negative if industry revenues were poised to decline more than 10% year-over-year through the next 12–18 months and weighted average industry gross margins were to fall below 15% during that period. This negative outlook, in our opinion, is more likely to result from an event-driven shock rather than from a major deterioration in industry fundamentals.

Exhibits

Exhibit 1

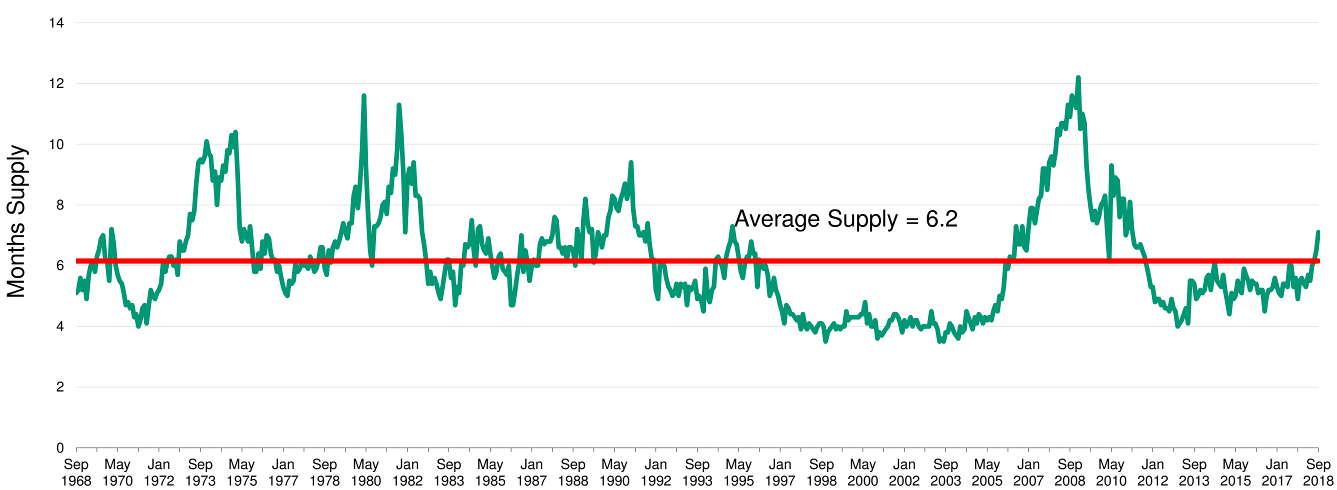
Affordability has declined for four consecutive quarters



Source: National Association of Realtors, Real Estate Outlook, US Census Bureau, US Bureau of Economic Analysis, Moody's Analytics Estimates

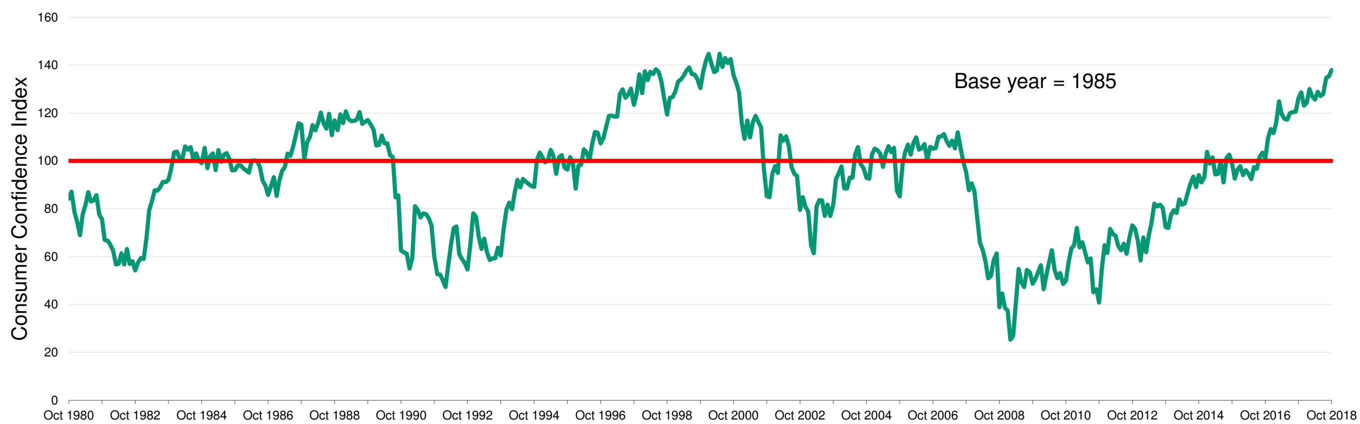
Exhibit 2

Inventory of new unsold homes reached seven months for the first time since 2011



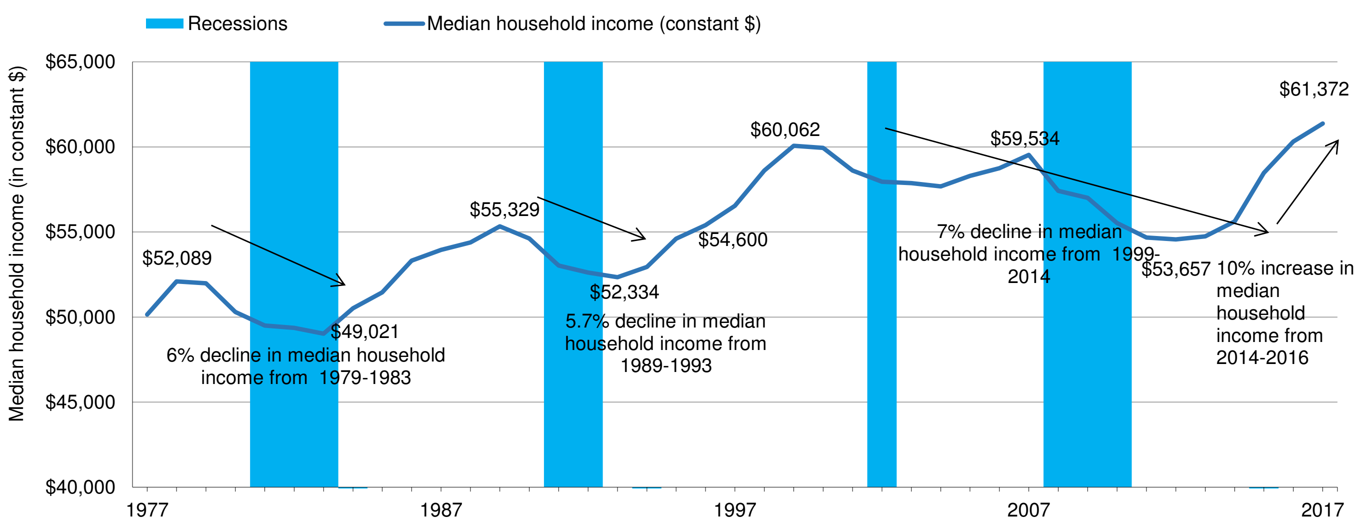
Source: US Census Bureau, Moody's Analytics

Exhibit 3
Consumer confidence at nearly 20-year high



Source: The Conference Board, Moody's Analytics

Exhibit 4
Median household income growing steadily



Source: U.S. Census Bureau, Current Population Survey, Moody's Economy

Exhibit 5

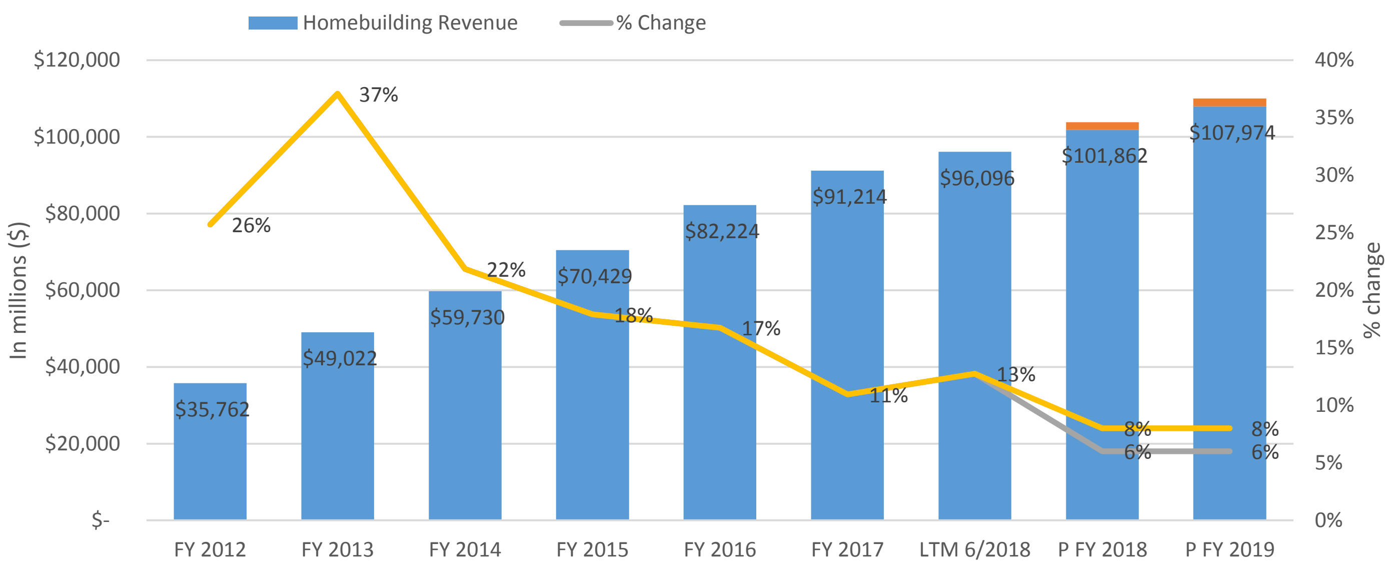
Macro Housing Data and Moody's Forecast

In 000's	2013A	2014A	2015A	2016A	2017A	2018P	2019P
Total Housing Starts	925	1,003	1,112	1,174	1,203	1,268	1,305
% YOY Change		**8.4%**	**10.9%**	**5.6%**	**2.5%**	**5.4%**	**2.9%**
Single-Family Housing Starts	618	648	715	782	849	887	915
% YOY Change		**4.9%**	**10.3%**	**9.4%**	**8.6%**	**4.5%**	**3.2%**
Multi-Family Housing Starts	307	355	397	392	354	381	390
% YOY Change		**15.6%**	**11.8%**	**-1.3%**	**-9.7%**	**7.6%**	**2.4%**
New Home Sales (defined as single-family)	429	437	501	561	614	625	640
% YOY Change		**1.9%**	**14.6%**	**12.0%**	**9.4%**	**1.8%**	**2.4%**
New Home Price Gains (median)	9.5%	6.9%	5.0%	4.6%	5.3%	1.0%	1.0%
Existing Home Sales (defined as both single- and multi-family)	5,090	4,940	5,250	5,450	5,510	5,400	5,450
% YOY Change		**-2.9%**	**6.3%**	**3.8%**	**1.1%**	**-2.0%**	**0.9%**
Existing Home Price Gains (median)	11.5%	5.7%	6.8%	5.1%	5.7%	4.2%	3.0%

Source: US Census Bureau, National Association of Realtors, Moody's projections

Exhibit 6

Revenue growth will be within 6-8% in 2019



Source: Moody's Financial Metrics, Moody's Projections

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