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US — Homebuilding

Increasing focus on first-time, entry-level homes will ease affordability challenges

» **Recent softening in US housing broadly reflects declining affordability.** With the first signs of weakening emerging in the third quarter of 2018, as reflected in softening of new orders, and continuing through the beginning of 2019, we now expect meaningfully reduced growth for the industry for the rest of the year, as indicated in our recent Homebuilding Outlook Update.

» **Low inventories of affordable homes — a persistent concern.** Total new unsold home inventories rose during the second half of 2018, to an average of 6.5 months of supply from a five-year average of 5.5 months. Yet, a lack of affordable homes has frequently appeared to be the reason buyers hesitate on making a purchase. This is exacerbated by a lack of urgency in light of moderating interest rates and slower home price increases.

» **Homebuilders are increasingly focusing on expanding their more affordable first-time and entry-level product categories.** To address affordability and demand challenges, homebuilders are more intensely pursuing this segment, which we believe will grow faster compared with other product types in the next 12-18 months — assuming the economic environment remains healthy.

» **Millennials will drive demand for housing over the next two decades.** Additionally, over the next few years we expect particularly solid growth so long as the job market remains strong. Millennials, the generation who are or will be ages 19 to 37 by the end of 2019, represent over a quarter of US population and are entering the housing market in increasing numbers as they reduce student-loan debt, build wealth, and form families.

» **Building homes efficiently will be key to encouraging demand and easing affordability concerns and for homebuilders to preserve gross margins.** With reduced pricing power, and the environment of higher incentives and discounts, preserving margins will depend on homebuilders' managing input costs and emphasizing efficient home construction. That includes standardizing floor plans, reducing square footage, and building in locations further from city centers.

» **Affordability will continue to be a challenge for the sector, but to a lesser degree.** The expectation that interest rate increases and home price increases will be more modest in the next 12-18 months compared to recent years supports homeownership cost economics, while the industry continues to benefit from a strong labor market and growing wages.

Affordable first-time and entry-level home sales to grow faster than other types

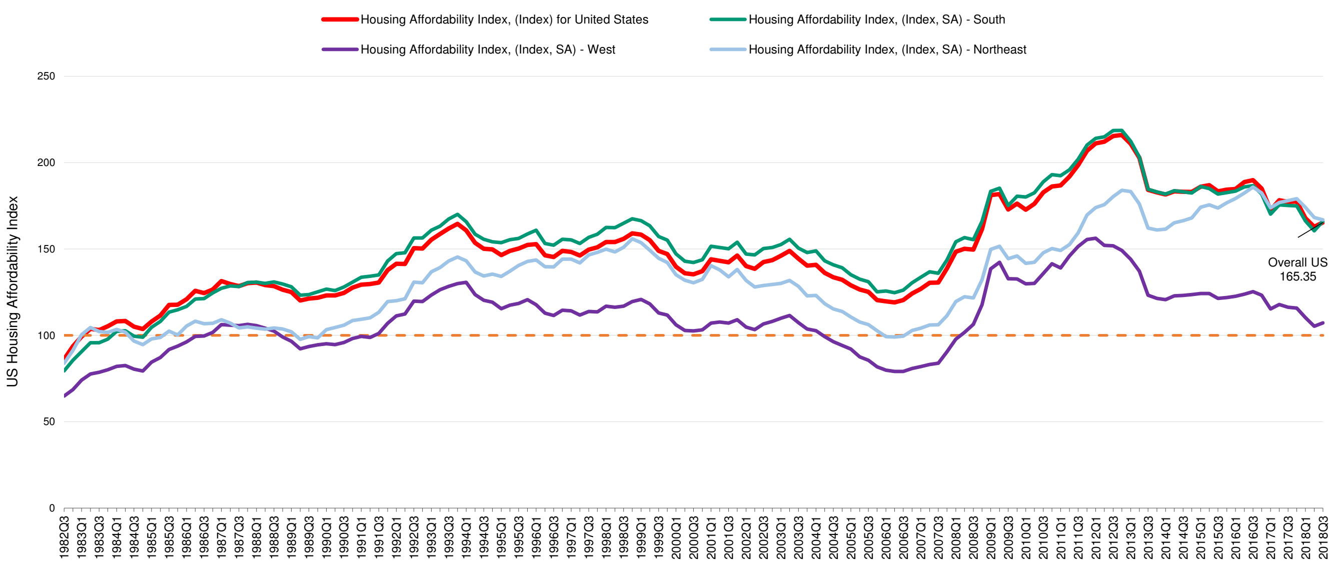
We expect lower-priced first-time and entry-level home segments to perform well in the next few years, assuming the economic environment stays strong and the job market accommodative, given the challenges of affording a house and the significant millennial population that is reaching the typical age for family formation and homeownership. Another population cohort that is served by the entry-level type of home are baby boomers, who look to downsize as they retire. We expect the demand in first-time and entry-level segments to be stronger than for move-up, active-adult, and luxury homes. However, first-time buyers are also most vulnerable to economic weakness and rapid changes in market conditions, including interest rates, and mortgage-qualification standards.

Lack of affordable homes reducing purchasing momentum

Declining affordability, the result of rapid, persistent home-price appreciation and increasing mortgage rates, is among the main reasons for the current slowdown in the US homebuilding industry. Home prices have risen steadily since the last recession, with both new and existing median home prices on a multiyear run of mid-single digit annual increases through 2017, following double-digit growth in the earlier stages of the housing recovery (see Exhibit 1.)

Exhibit 1

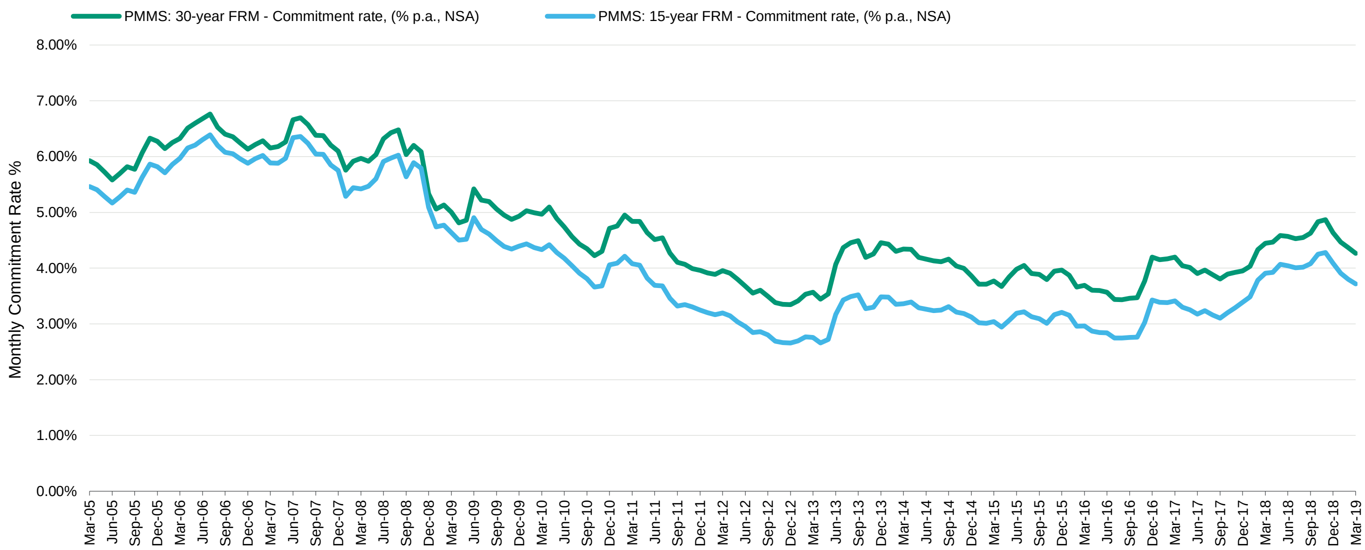
Broadly declining affordability across the US



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

Although, interest rates have eased somewhat in early 2019, mortgage rates had gradually increased since the H2 2017, with 30-year fixed rate reaching 4.87% in November 2018, the highest level since February 2011 (see Exhibit 2.)

Exhibit 2
Mortgage rates reached multiyear highs in late 2018



Source: Freddie Mac: Primary Mortgage Market Survey

The decision to buy a home, particularly for the first-time buyer, often depends on an all-in monthly homeownership cost, which includes mortgage, property taxes, homeowner's insurance, and maintenance. In their decision to purchase, homebuyers consider the affordability of the required monthly payment, which is sensitive to changes in both price and interest rates. With home prices and mortgage rates rising rapidly, monthly cost may have exceeded the comfort range for many, thus discouraging some buyers. Affordability in the US has generally trended lower, from the five-year peak of 2016 and from the all-time peak of 2012, as shown by the US Housing Affordability Index, indicating a weakening ability of qualifying for a mortgage on the median price of a home while earning the median household income. Affordability challenges are different by region, with the Western US experiencing the most protracted weakness. Such imbalances have prompted migration to more affordable regions from coastal areas, states with high property prices, and ones with high income and sales taxes.

The shortage of inventory of affordable homes for sale magnifies these issues. Buyer hesitation has increased significantly as home listings stay on the market longer. Lack of variety and available inventory at affordable levels in desired locations, as well as a lack of urgency from buyers' perspectives, given moderating interest rates and home prices, are frequently the reasons for delays in purchasing.

Homebuilders increasingly focusing on expanding first-time, entry-level home construction

Most US homebuilders have been operating in the first-time and/or entry-level market segments for years, as these products address a significant share of overall demand for homes. However, with persistent and intensifying affordability challenges and recognizing buyers' pursuit of lower-priced homes, many homebuilders put more resources into focusing on the segment and expanding more-affordable product offerings in recent years. Product mix for many builders has therefore evolved to include a higher proportion of first-time and/or entry-level homes. We expect this trend to continue and see larger, geographically-diversified and well-capitalized companies as better positioned to adapt.

Homebuilders' product categories may be based on varying data points and are not necessarily comparable. Some builders categorize their product mix based on the buyer profile derived from surveys of home purchases. Others estimate product mix based on categorization of communities for intended buyers. For example, communities may be categorized as entry-level, being primarily geared toward first-time buyers, however, they may include sales to move-down or move-up buyers. Other builders obtain buyer information based on mortgage applications, which is a more precise method of determining first-time buyer exposure. This information is available in particular if buyers utilize homebuilders' mortgage subsidiaries. Given these differences, we view product detail mentioned below more as a general observation based on each homebuilder's own categorization and available data points.

A number of homebuilders have developed various targeted brands and product lines focusing on entry-level and first-time homes, some of which include:

» "Express" and "D.R. Horton" brands by D.R. Horton, Inc. (Baa3 stable) focus on affordable entry-level housing, and first-time / first-time move-up homebuyers, respectively. The Express brand with $241,000 average selling price, represented 37% of the company's total deliveries in fiscal 2018. The company's closings to first-time buyers through its mortgage subsidiary (with a capture rate of 56%) represented 47% during the year.

» "Centex" brand by PulteGroup, Inc. (Ba1 stable) focuses on the first-time homebuyer segment. The company's homes in this segment tend to be smaller by square footage and have lower average selling prices or higher density. About 28% of Pulte's closings in 2018 were attributed to the first-time customers.

» "LiVE.NOW" communities by Meritage Homes Corporation (Ba2 stable) focus on entry-level homebuyers by providing well-appointed, but lower-priced homes built on-spec with quick delivery times, and are characterized by simplified and standardized construction and design center selection processes. The company's entry-level product represented 41% of sales in 2018.

» "Seasons" collection by M.D.C. Holdings, Inc. (Ba2 stable) offers affordable homes for the first-time buyer. First launched in 2016, the Seasons collection and other affordable products represented 25% of the company's closings in 2018.

» "Smart Series" product by M/I Homes, Inc. (B1 stable) targets affordable price ranges and offers smaller square footage and pre-selected finishes and upgrade packages, representing around 11% of 2018 sales, with an average selling price of about $295,000. Approximately 35% of the company's deliveries through its mortgage subsidiary (with a capture rate of 80%) in 2018 were to first-time buyers.

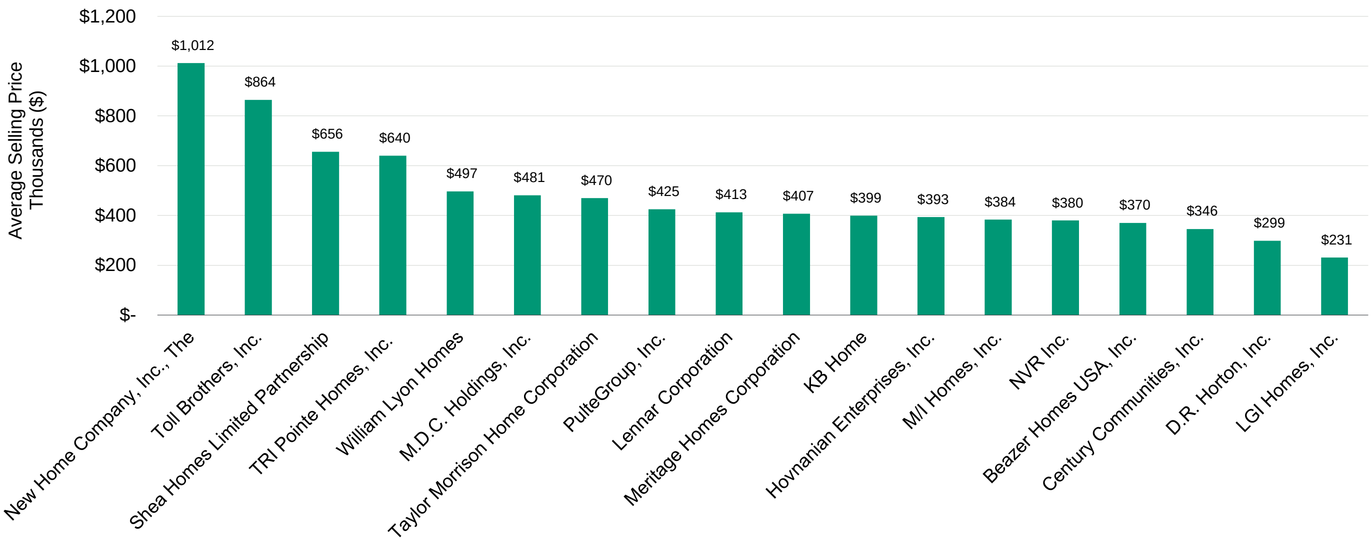
» "LGI Homes" brand by LGI Homes, Inc. (B1 stable) sells attached and detached entry-level, and move-up houses. With entry-level being the company's primary operating focus and representing about 90% of closings, LGI's average selling price of $231,000 is the lowest among the rated public homebuilders.

» The "Century Complete" line and "Wade Jurney Homes" brand by Century Communities, Inc. (B2 stable) focus on the entry-level segment and provide limited product designs and options. Overall 75% of the company's closings in 2018 were geared to entry-level buyers based on FHA loan qualifications.

In addition to the homebuilders mentioned above, other companies reporting a significant exposure to the first-time market in fiscal 2018 include: Beazer Homes USA, Inc. (B3 positive) with 55% of closings; KB Home (B1 positive) with 51% of deliveries; and Hovnanian Enterprises, Inc. (Caa1 stable) with 31% of deliveries. Others with significant exposure to entry-level in fiscal 2018 include: William Lyon Homes, Inc. (B2 stable) with 52% of deliveries; New Home Company, Inc. (B3 stable) with 44% of deliveries; Lennar Corporation (Ba1 stable) with 36% of deliveries; Tri Pointe Homes, Inc. (Ba3 stable) with 27% of deliveries; Shea Homes Limited Partnership (B1 stable) with 26% of deliveries; Taylor Morrison Communities, Inc. (Ba3 stable) with 22% of sales; and as of November 2018, Ashton Woods USA, LLC (B3 stable) with 39% of closings.

We expect rated homebuilders offering first-time and entry-level products at lower prices will capture stronger demand trends, with those segments growing at a higher rate than other product types and also faster than first-time/entry-level homes offered in geographic regions that are less affordable such as: the Western US, coastal areas, major metro areas, or high tax-rate states. A first-time home in such regions is generally priced much higher than the national average, sometimes at multiples.

Exhibit 3
Average selling price of homes from public builders in 2018 ranged broadly



Source: Company filings, Moody's Financial Metrics

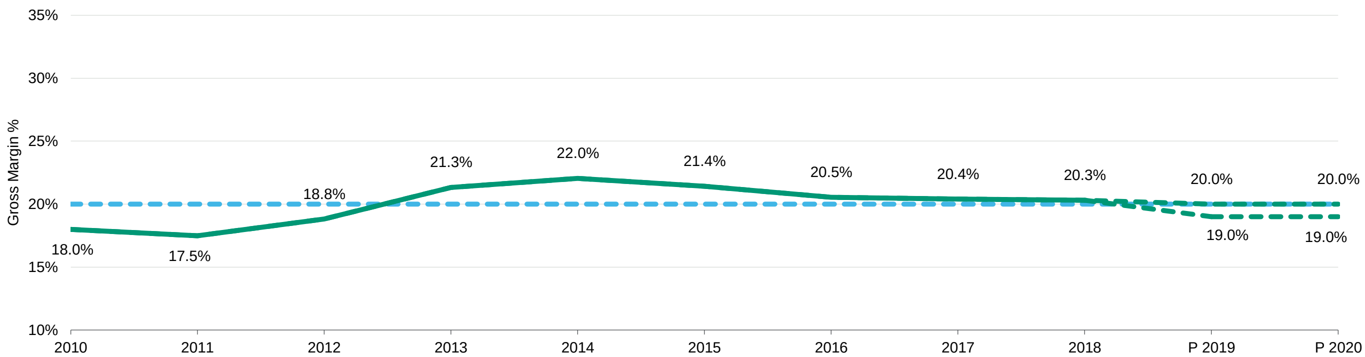
Efficient construction key to encouraging demand, preserving margins

In 2019, we expect GAAP gross margins for the industry to be 19% to 20%, versus 20.3% in 2018, with some companies maintaining generally stable margins, while others see modest weakening compared to the 2018 levels. In an environment characterized by softer demand, homebuilders have less pricing power compared to prior years and now offer more incentives in the form of mortgage buydowns, no-charge upgrades and the like, to address affordability and encourage demand. Previous robust price increases helped offset rising input costs, including land, labor, and materials, preserving or improving margins. Conditions are now more difficult. Input costs remain high, with prices for certain materials rising because of tariffs, compelling efforts to build homes more efficiently to preserve gross margins. The cost of lumber, which has moderated, will offset these pressures to a degree.

To make homes more affordable and reduce construction costs, companies have been standardizing floor plans, the associated design packages, and construction processes, using more off-site building, reducing the square footage of homes, and choosing more outbound, suburban locations where land is cheaper. Other efficient operating techniques include: pursuing land acquisitions in bulk; employing large-scale centralized purchasing of building materials; using generic versus branded building materials; and utilizing social media and digital advertising and sales tactics.

This focus on the affordable home segment means certain companies will build a higher amount of homes on-spec (homes constructed without a purchase order) with a goal to meet market demand at this level more quickly. Having a higher proportion of speculative home inventory is generally more risky during a downturn, since it exposes the builder to the risk of holding inventory when demand declines, having to offer discounts or take major impairment charges if home prices decline. However, we consider the current environment stable, therefore having a higher proportion of speculative home construction, predominantly targeted on first-time homebuyer, is not particularly concerning given the expectation that demand in this market segment will remain healthy over the next couple of years.

Exhibit 4
Homebuilding gross margin expectations diminished



All figures are calculated using Moody's estimates and standard adjustments
Source: Moody's Financial Metrics, Moody's Projections

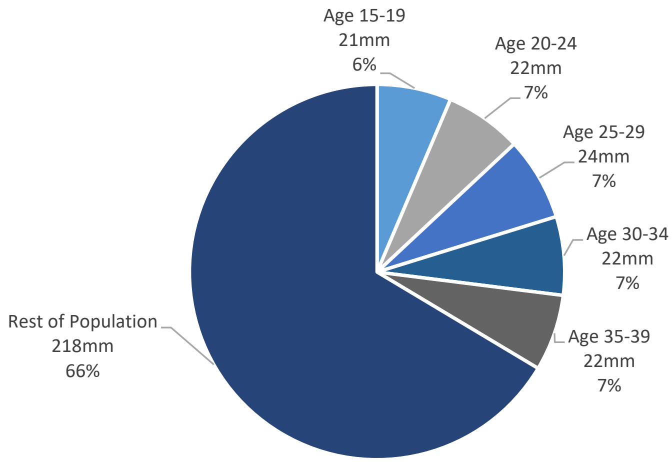
Millennials will drive demand over the next two decades

Demographics suggest there is significant demand for entry-level homes in the near future. Millennials, defined by the US Census Bureau as the generation born between 1982 and 2000, represent a significant share of the overall national population. Millennials, a larger group than even the baby boomer generation, and are entering the housing market in increasing numbers and should drive demand over the next two decades.

Millennials, who are or will be ages 19 to 37 by the end of 2019, have thus far tended to form families and purchase homes later in life compared to prior generations and a significant proportion of the group is reaching the more typical age for family formation and homeownership for this generation. This should bode well for demand as they gradually build wealth and strengthen their financial position through employment, savings and reduction of education debt, as well as form families and have children. Due to the challenges this group faces in saving for the down payment, family support helps incentivize home purchasing. We believe millennials will be the largest segment of population pursuing home purchasing in the next two decades, and expect demand from this segment to be solid so long as the job market remains strong, supporting household formations.

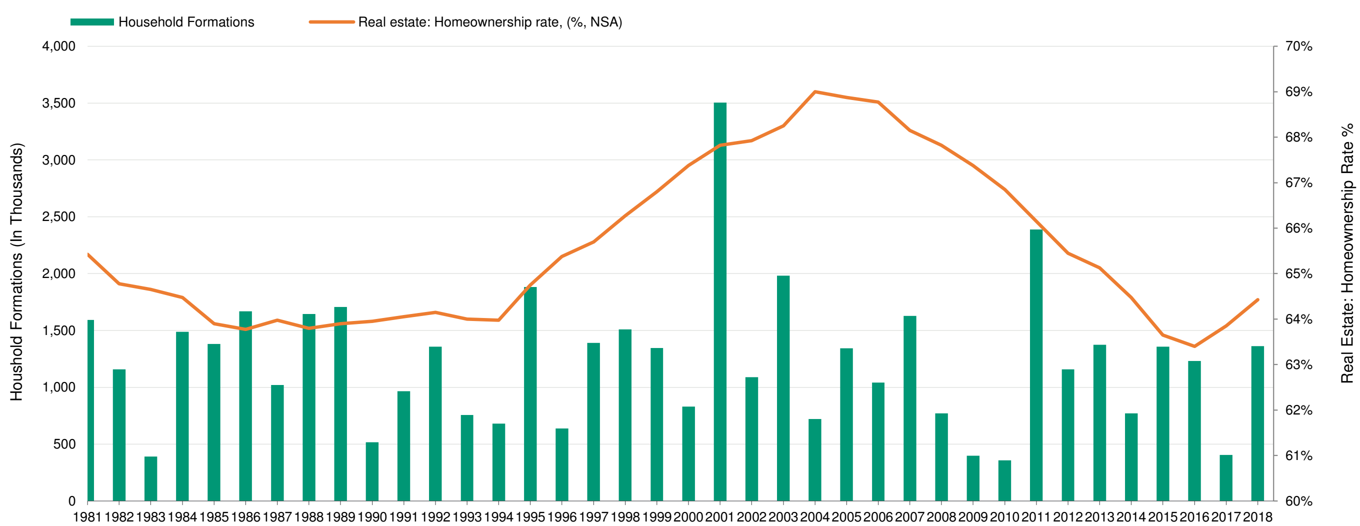
To better attract millennial buyers, homebuilders have adjusted to various new specification desires such as: open space; connectivity and smart technologies in buildings; security systems such as video doorbells and electronic locks; locations with proximity to lifestyle choices and activities; as well as a simplified and efficient home-shopping process.

Exhibit 5
Millennials outnumber even Baby Boomers



Millennials defined by US Census Bureau as those born between 1982 and 2000. Ages 18 to 36 as of 2018
Source: US Census Bureau, Moody's Analytics

Exhibit 6
Total US household formation, homeownership begin to tick higher



Source for Household Formations: U.S. Census Bureau, Current Population Survey, March and Annual Social and Economic Supplements

Source for Homeownership Rate: U.S. Census Bureau (BOC)

Affordability challenges are a headwind, albeit moderating

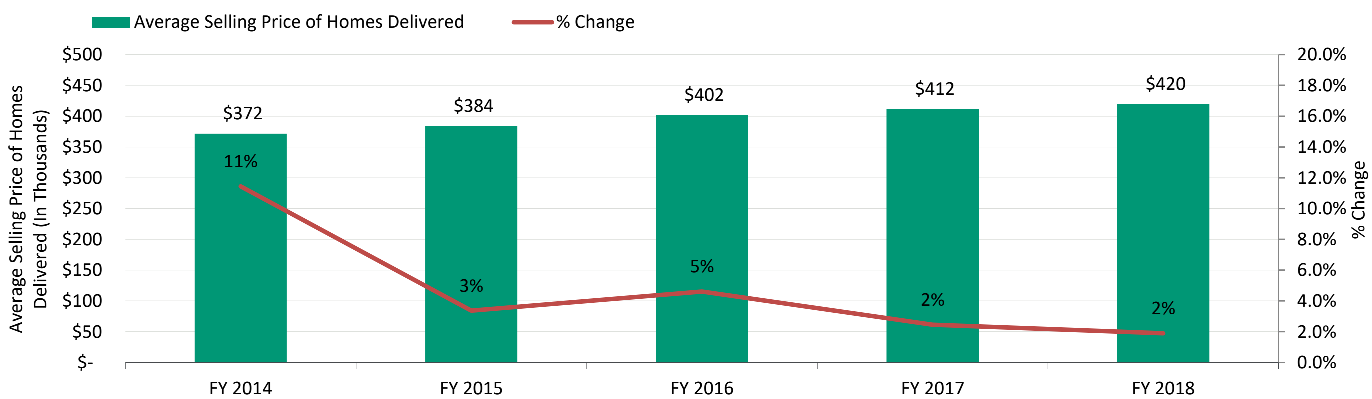
We foresee affordability continuing to be a challenge for potential homebuyers over the next 12 to 18 months. However, homebuilders' pricing power has weakened since the H1 2018 as they are no longer able raise prices as much and as easily given the persistently moderating demand. Over the next year, we expect homebuilders to increase prices only up to 1% on average compared to growth in the low- to mid-single digit range in recent years, and double-digit growth during the early stages of the housing recovery. Homebuilders' average selling price trends of recent years already incorporate product mix shifts to lower price points, otherwise the magnitude of price increases would have been greater. This will persist. Mortgage rates that moderated somewhat since the end of 2018 have also supported home sales. As of the end of March 2019, the 30-year fixed mortgage rate stood at approximately 4.26%, down from the recent peak of 4.87% in November 2018. Longer term, we expect a continued rise in mortgage costs, although at a more gradual pace compared to the previous trajectory, as the Federal Reserve increases interest rates.

Assuming employment conditions and wage growth continue to be strong, we believe a mixture of factors will help make homes more affordable. These include: slower growth in home prices given the reduced pricing power of homebuilders, mortgage rate increases at a more moderate pace, and more affordable home inventory coming to market over the next few years.

Homebuilders more heavily participating in the affordable home construction segment, particularly those with more efficient operations, should benefit from the growing first-time and entry-level market segments over the next couple of years and demonstrate higher growth within these segments compared to other product categories, particularly the higher-end homes.

Exhibit 7

Home price continuing to rise, but rate of increase slowing



Aggregate average selling price of homes delivered of rated homebuilders

Source: Moody's Financial Metrics

Moody's related publications

- » Outlook Update: Stable view reflects healthy fundamentals, but meaningfully slowing growth, March 2019
- » Homebuilding Outlook: Slower growth, increasing headwinds, prompt outlook cut to stable from positive, November 2018

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