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October 2019

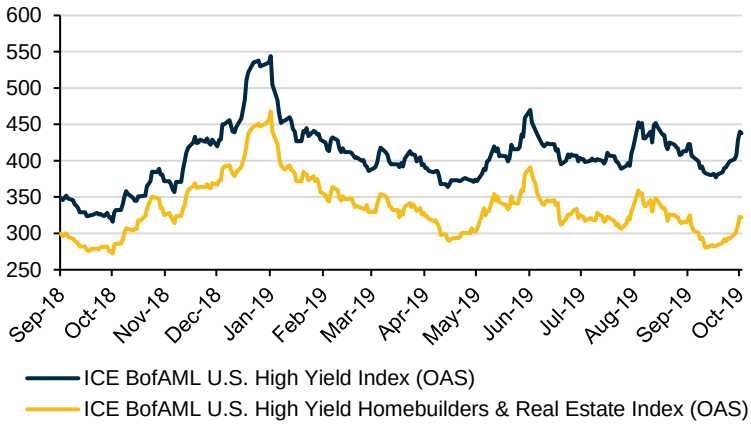
Homebuilders as a Case Study in Late-Cycle High Yield

For some high-yield investors, the U.S. homebuilding sector may represent a crossroads for the higher-rated portions of the market. With a total return of 14.22% through early October 2019, homebuilders have solidly outperformed the broader high yield market and the BB-rated portion of the market (total returns of 11.02% and 12.79%, respectively).[1] Yet, as concerns about an economic slowdown mount, investors may be facing a highly-cyclical sector that generally appears fully valued and possibly on the precipice of weakening economic conditions.

In the context of an example of investing in an inherently cyclical sector in a late-cycle environment, this paper looks at some key developments with homebuilders that have supported an overweight allocation to the sector and how this allocation has adjusted to the maturing cycle.

With the Federal Reserve still in tightening mode as global economic uncertainties mounted in late 2018, spreads in the U.S. high yield market and the homebuilding sector widened by 228 bps and 196 bps, respectively (see Figure 1). At the time, homebuilding bonds appeared oversold as the sector, which consists of mostly BB-rated credits, only traded 27 bps inside of the broader market.[2]

Figure 1: Homebuilder Spreads Appeared Attractive After Widening in Late 2018



Source: ICE Index Platform as of October 4, 2019

Furthermore, the selloff came amid the sector's fundamental backdrop of historically restrained activity, adjustments to changing market dynamics, and stabilized leverage levels. Our overweight allocation to the sector generally consisted of longer-dated issues (amid relatively steep yield curves) from higher-quality credits and lower-quality names with improving credit profiles.

[1] *Total returns are based on the ICE BofA ML indices as of October 4, 2019.*
[2] *October 25, 2018.*

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Recovery Amid Restraint

For a sector with tailwinds from low interest rates, pent-up demand in the aftermath of the Great Recession, and improved levels of disposable income, homebuilders' activity has been conspicuously subdued in recent years. The restraint is observable not only in terms of the prior run-up in housing prices through 2005, but also in a more historical context. With less than 1.2 million units completed in 2018, recent housing completions remain consistent with the troughs of prior cycles, such as those in the early 1990s and 1982 (Figure 2).[3] It's a similar story in terms of housing's broader economic effect as its 4% share of U.S. GDP only remains slightly above levels previously seen after recessions (see Figure 3).

Figures 2 and 3: Housing Completions and Housing's Share of U.S. GDP Remain Near Recessionary Levels

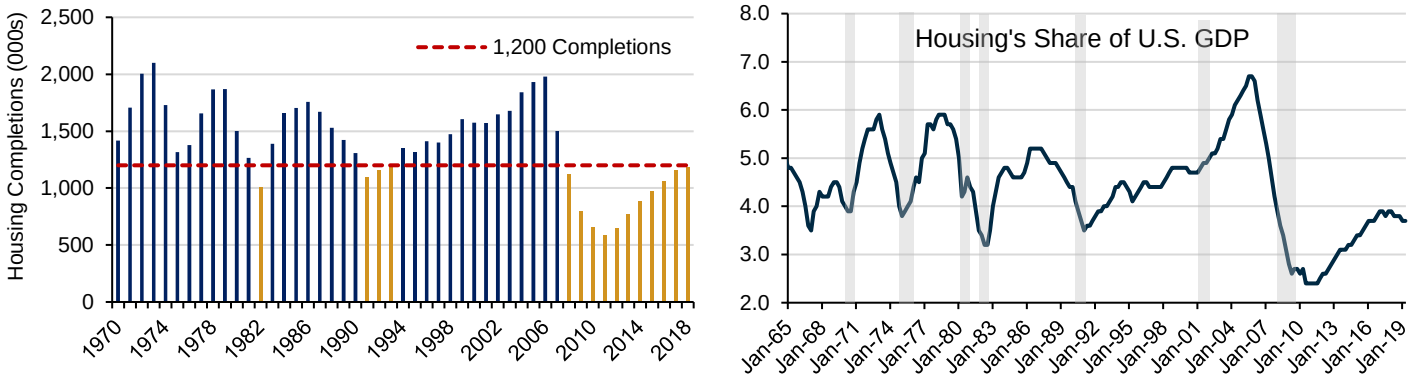


Figure 2 source: U.S. Department of Housing and Urban Development; Completions of privately-owned housing units. Figure 3 source: U.S. Bureau of Economic Analysis and the St. Louis Federal Reserve. Shading represents periods of economic recession.

Several factors have limited homebuilders' activity in recent years. As the U.S. housing market has recovered over the past decade, the median home price has risen nearly 50% to $307,000 (see Figure 4), reducing the pool of potential homebuyers. Factor in tighter mortgage lending standards, and the pool has been reduced even further.[4] In addition, land prices have risen in recent years as builders have worked through the relatively inexpensive land parcels that became available during the Great Recession. On the labor side, construction job openings have steadily risen to the point where they are nearly in line with the industry's hiring rate (see Figure 5), indicating potential exhaustion of the available labor pool with recent immigration developments likely contributing to the shortage. The tight labor pool has resulted in higher construction wages across the industry.

Figures 4 and 5: Rising U.S. Home Prices (With a Recent Turn) and the Tightening Construction Labor Market

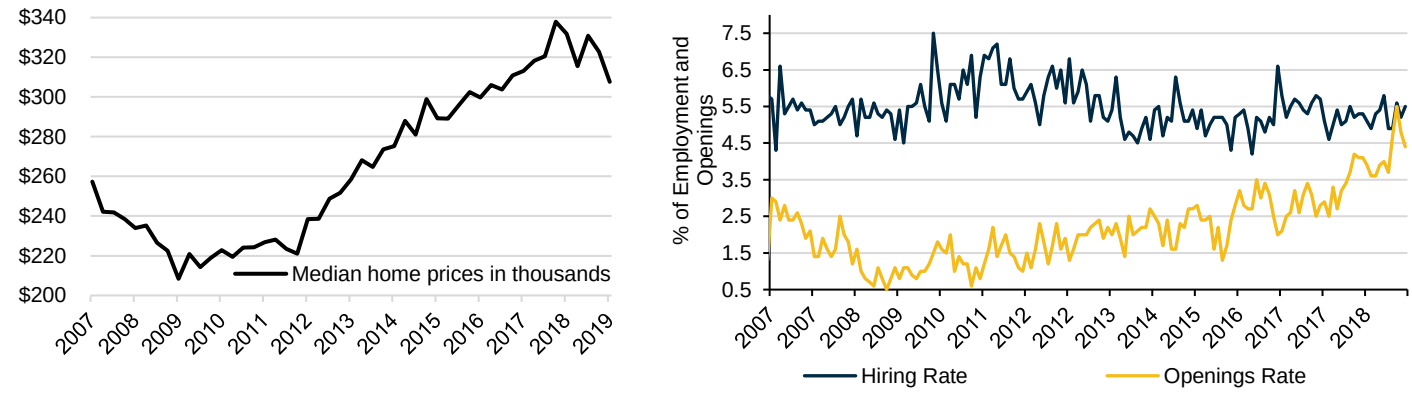


Figure 4 source: U.S. Census Bureau. Figure 5 source: Bureau of Labor Statistics. The rates are as a percentage of total employment plus current job openings.

[3] *The large role of the technology sector in the 2001 recession kept activity in the housing market high relative to prior recessions.*

[4] *Under the Ability-to-Repay/Qualified Mortgage (ATR/QR) rule, lenders are required to consider eight specific underwriting standards, at a minimum, and to make a reasonable, good-faith determination that a borrower can repay a covered mortgage loan before, or when, the lender consummates the loan. This clearly contrasts the pre-crisis environment when borrowers with low FICO scores with no income, job, or assets were sometimes able to secure financing for up to 100% of a home's purchase price.*

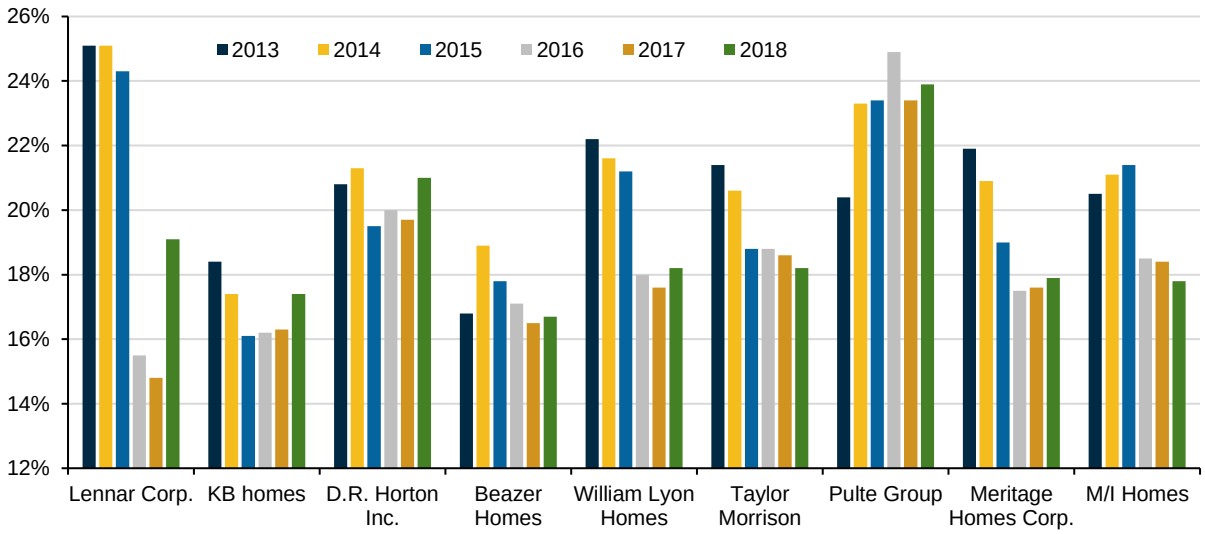
Effects on Fundamentals

The increase in home prices and relatively stagnant pool of buyers has prompted many homebuilders to lower their average sale prices. For example, Meritage Homes reported an average sales price of $408,000 in Q2 2018, and it declined in each subsequent quarter to $383,000 by Q2 2019. Yet, the company's closed sales over the same timeframe climbed 5.3% to 2,253.[5]

The shift to lower priced homes cuts two ways for homebuilders: it is an important step in supporting demand considering that the front end of the Millennial generation—set to surpass Baby Boomers as the largest U.S. generation—is finally entering the housing market. However, for most of the industry, the combination of lower sale prices and rising costs in recent years has squeezed margins from both sides. The average gross profit margin for the group of homebuilders with publicly traded debt in Figure 6 declined from nearly 21% in 2013 to about 18% in 2017.

Yet, many credits in the industry have adjusted course in an attempt to maintain or improve margins going forward. For example, builders have reduced construction costs by reducing floorplan choices and other customer options, constructing more parts offsite (such as frames and trusses), and improving subcontractor scheduling. As a result, gross profit margins for most of the credits in Figure 6 finally stabilized in 2018, rising slightly to an average of nearly 19%.

Figure 6: Increased Costs and Pricing Pressure Have Squeezed Homebuilders Gross Margins in Recent Years

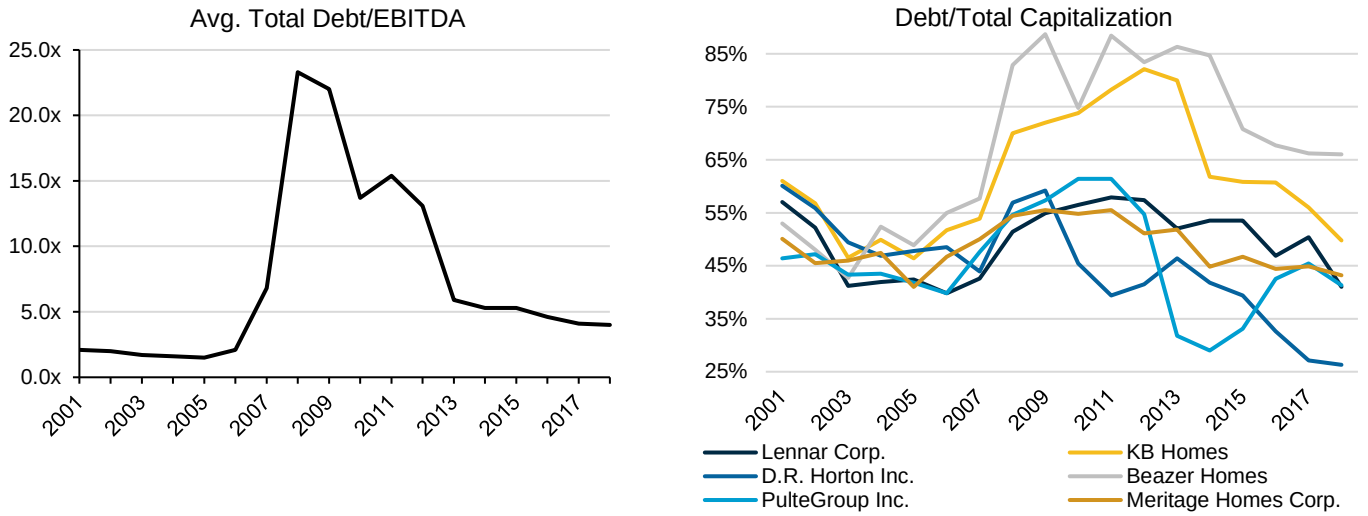


Source: Company SEC filings and PGIM Fixed Income estimates as of March 31, 2019

[5] *http://investors.meritagehomes.com/FinancialHighlights?keyReport=-226*

From a balance-sheet perspective, the homebuilding industry's relative restraint and stabilizing profit margins—coupled with the industry's recollection of the experience during the Great Recession—have also supported a recovery. The industry's average total debt/EBITDA has declined from more than 20 times during the crisis to 4 times as of the end of 2018 (Figure 7). While Figure 8 shows the general reduction in individual credit's debt/total capitalization in recent years, the specific performance varied widely in the aftermath of the recession. With only one credit with publicly issued debt (D. R. Horton) clearly running with materially lower leverage than before the recession, this variation may explain why the industry's average debt/EBITDA leverage remains above the level from 2006 (again Figure 7).

Figure 7 and 8: Most Homebuilders Have Delevered, But Industry Leverage Remains Above Pre-Recession Levels



Source for Figure 6: Company SEC filings and J.P. Morgan Esitmates. Source for Figure 7: Company SEC filings.

Still Mostly a High Yield Sector, And Likely to Remain So

While credit quality appears to be improving, we expect most names in the sector to remain below investment grade for two related reasons. First, the rating agencies appear highly cautious about upgrading homebuilding credits to investment grade, possibly due to the negative backlash they received during the Great Recession, and the agencies appear to be holding the industry to higher upgrade standards. For example, only two homebuilders currently have investment grade ratings from Moody's Investors Service compared to eight credits in 2007. Second, most management teams appear unwilling to meet the higher bar for an investment grade credit rating, which would likely require further deleveraging and foregoing shareholder friendly actions, such as dividends and/or share buybacks. And the low interest-rate environment largely mitigates the need for most companies in the industry to attain investment grade status and marginally lower borrowing costs.

However, from the perspective of current operating trends, we believe Pulte Group (BB+) and Toll Brothers (BB+) could join D.R. Horton and NVR Inc. in the investment grade universe if their improving credit metrics remain on course to meet the agencies' higher upgrade threshold.

Adjusting to the Cycle

If the BB portion of the high yield market exemplified an investment "sweetspot" in early 2019—offering yield without the incrementally higher risk of Bs and CCCs amid the economic uncertainty—homebuilders may have been a "sweetspot" in the BB segment given the fundamental tailwinds and recent developments within the sector. Yet, with homebuilding OAS tightening by 129 bps in 2019 to 322 bps as of early October (relative to the YTD OAS tightening of 100 bps to 260 bps for the BB-rated portion of the market), some of the longer-dated homebuilding issues appear nearly fully valued, raising a couple of implications.[6] First, while we're maintaining an overweight allocation to the sector, we've adjusted our positioning to the shorter end of the spread curve. Second, when initially overweighting the sector, our analysis and selection of lower-quality credits has enabled use to maintain some of our longer-dated positions. For example, Ashton Woods

[6] *At the time of publication, we viewed BBs, in general, as overvalued and were seeking opportunities in Bs and CCCs, offset by holdings of AAA CLOs where permissible.*

(B-) is another credit that has benefitted from pivoting to lower-priced homes, and its recent spread of 496 bps remains attractive relative to the broader market's OAS of 438 bps.

At some point in the cycle, when homebuilders start feeling the cyclical headwinds and spreads widen accordingly—possibly converging toward the OAS of the broader high yield market as they did in late 2018—we could again move out on the spread curve in the homebuilding sector. Our general comfort with the sector's cyclicality in a weaker economic backdrop is based on the sector's ongoing restraint, readiness to adapt to industry challenges, and incoming demand from Millennials, all of which have the sector in a far better place to weather a recession relative to a decade earlier.

Conclusion

In many ways, the homebuilding sector may exemplify other high-yield cyclical sectors—i.e. it's nearly fully valued while possibly on the verge of weakening economic conditions—and this position underscores the importance of credit analysis and security selection in a late cycle-environment. Our view of developments in the sector since 2008 leave us comfortable shifting along the spread curve in high-quality homebuilding names while maintaining exposure to longer-dated, lower-quality issues from names where fundamental credit improvements appear likely.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of September 2019.

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