

Entry-Level to Drive Next Leg of Homebuilding Growth

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BI Industry Analyst

1. Entry-Level Market a Growth Opportunity for U.S. Homebuilders

12/06/16

(Bloomberg Intelligence) -- The entry-level market may present a meaningful growth opportunity for U.S. homebuilders as favorable demographic and macroeconomic trends confront a limited supply of lower-priced homes in both new and existing markets. That said, the market is not without its challenges, including rising land and regulatory costs, which have made it more difficult to deliver low-priced homes this cycle. As a result, homebuilders are taking a variety of approaches to tackle a growing market opportunity.

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Peer Comparison: LGI Homes (99%) has the most exposure to the entry level, followed by Beazer (60%), KB Home (51%), D.R. Horton (45%) and M/I Homes (39%). TRI Pointe, Century Communities, Pulte, Lennar, William Lyon, MDC, Hovnanian, Taylor Morrison, CalAtlantic, Meritage, NVR and UCP also have meaningful exposure.

Key Points:

- Demographic Tailwind: Demographics Lay Foundation for Builder Entry-Level Opportunity
- Mortgage Market Open: Attention First-Time Buyers: Mortgage Market Open for Business
- A Play on Inventory: Resale Market May Not Be an Outlet for Entry-Level Homebuyers

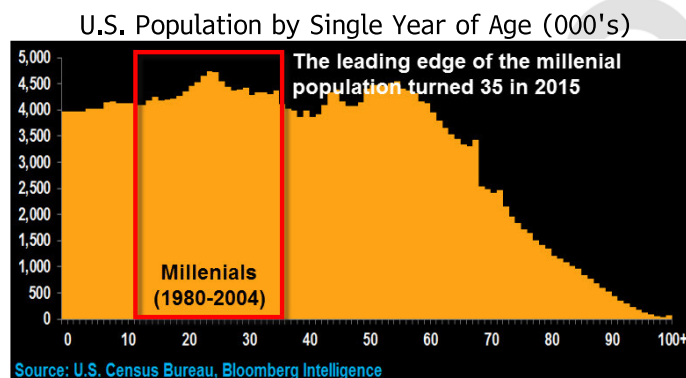
Entry-Level Opportunity

Demographic Tailwind

2. Demographics Lay Foundation for Builder Entry-Level Opportunity

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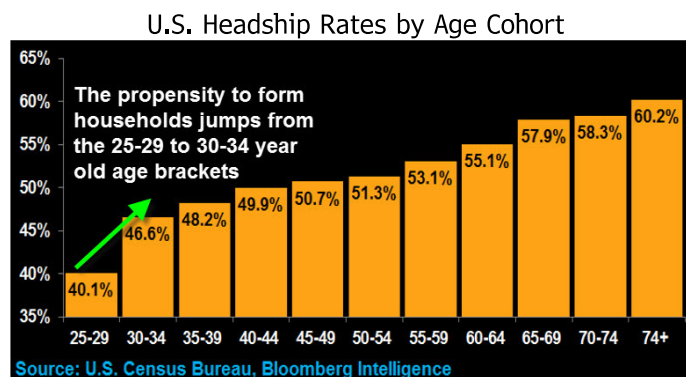
Millennials, loosely defined as those born between the early 1980s and 2004, were 33% of the U.S. population as of 2015 and will be influential in determining future housing demand. The average age of a first-time homebuyer is 33 years, according to Zillow. This means the leading edge of this demographic is only now approaching a more typical homebuying age in today's economy. Millennials will provide a key source of housing demand for years, given those ages 20-25 make up the largest populations among this group.



3. Entry Level Stands to Benefit From Millennial Household Growth

12/11/16

Regardless of whether the millennial population opts to rent or own homes, the sheer size of the demographic will result in significant household growth over the next decade. Headship rates, or the propensity of a given age group to form a household, show the largest percentage increase in the 30-34-year-old cohort. This happens to correspond with where the leading edge of the largest population group in the U.S., the millennials, has reached.

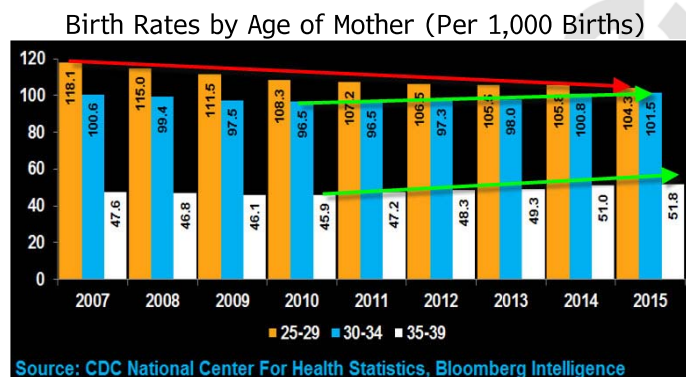


Household growth among this demographic has been impacted by both cyclical and structural forces. While this population may prefer renting, its significant size will result in strong growth in both the rental and for-sale markets.

4. Having Children Later Likely Contributing to Delayed Home Buying

12/06/16

Millennials have shown a propensity to live with parents longer, rent longer and to get married and have children later. Data from the CDC show that birth rates, based on mothers aged 25-29, have been steadily declining since at least 2007. Given home purchasing decisions are driven in part by life-cycle milestones, this has likely contributed to the more-muted growth in entry-level housing this cycle. That said, birth rates for mothers aged 30-34 and 35-39 have been on the rise over the last five years.



This may indicate that at least a portion of purchasing decisions are the result of these life-cycle "delays." With a large portion of the population moving toward what has become a more commonplace age to have children, it stands to reason that household formation will expand.

Jobs & Wages Rising

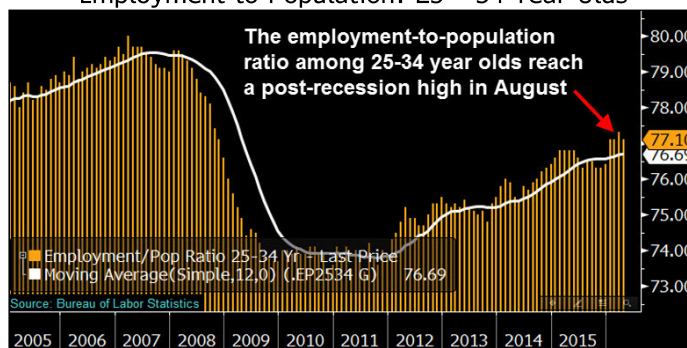
5. Employment of 25-34 Age Group Bodes Well for Entry-Level Housing

12/06/16

The employment picture for the younger age cohort, particularly those 25-34, has steadily improved since flatlining in 2H15. The employment-to-population ratio among this group reached a post-recession high of 77.8% in August and now stands at 77.5%. Employment gains in this group are crucial to driving higher volume growth in the U.S. homebuilding industry. Sustained improvement may bode well for builders, particularly as an increasing number shift product strategies to target the entry level.

Companies Impacted: LGI has 99% entry-level exposure, followed by Beazer (60%), KB (51%), Horton (45%), M/I (39%), TRI Pointe (35%) and Century Communities (35%).

Employment to Population: 25 - 34 Year Olds

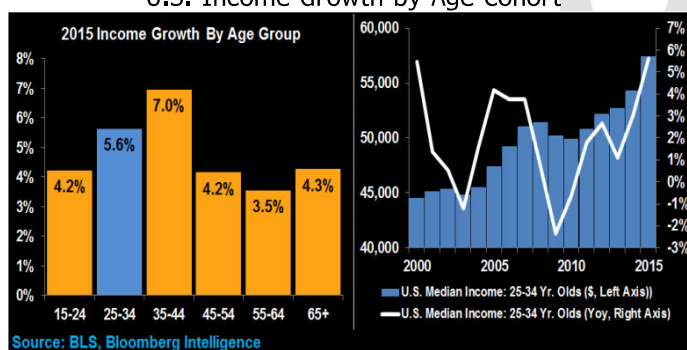


6. Income Growth Among Younger Cohort Key In Converting Renters

12/06/16

Rising incomes for 25-34-year-olds, who were important contributors to the U.S. housing market's growth pre-recession, may be critical to converting renters into homeowners. In 2010-14, the group's income growth averaged 1.6% annually, topping only the 55-64 demographic's 1.3% increase. Such a small advance and spiking rental costs, in particular, had constrained the younger set's ability to afford housing, be it via down payment on a new home or higher monthly rent payment.

U.S. Income Growth by Age Cohort



Census data show that incomes for those aged 25-34 rose 5.6% in 2015, trailing only the 7% growth for the 35-40 cohort. Further gains for the younger age group will be key in converting renters into homeowners, particularly as rising rents consume more disposable income.

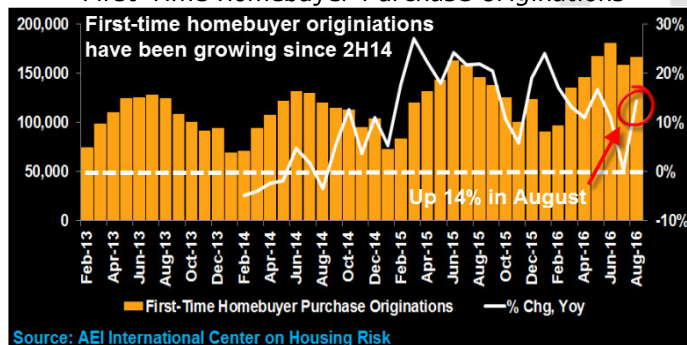
Mortgage Market Open

7. First-Time Homebuyers Have Been More Active Than Perceived

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Mortgage purchase originations among first-time homebuyers have been expanding since 2H14, highlighting a continued improvement in demand among this buyer segment, despite the perception of inactivity. In August, purchase originations expanded by 14% from the previous year, according to data from the AEI International Center on Housing Risk. This corroborates commentary from builders who have been more aggressively targeting the entry level (fueled by first-time buyers), noting strong demand.

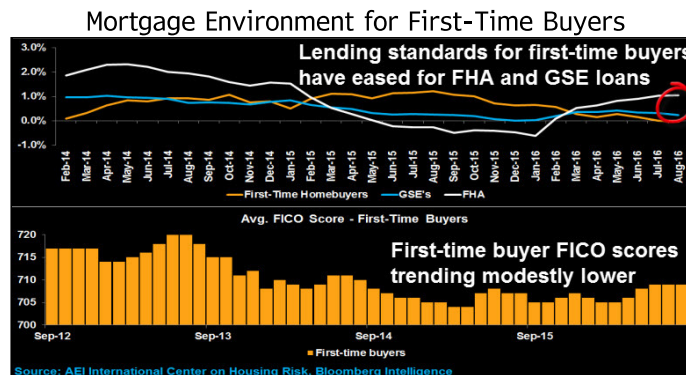
First-Time Homebuyer Purchase Originations



8. Attention First-Time Buyers: Mortgage Market Open for Business

12/06/16

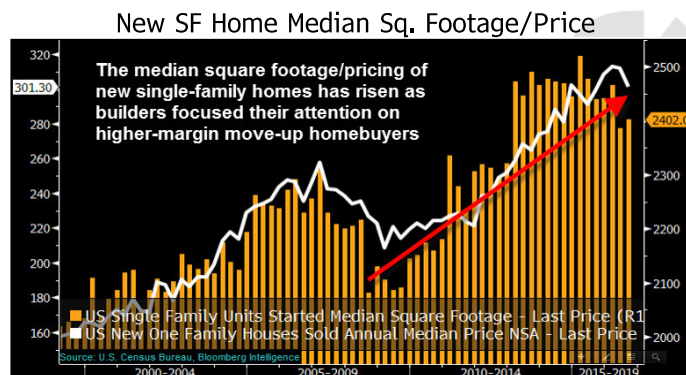
The perception that first-time homebuyers are unable to gain access to mortgage financing may be muting the potential for demand. On the contrary, mortgage lending standards for first-time homebuyers have been improving for much of the current cycle, based on data from the AEI International Center on Housing Risk. This is particularly true for FHA and GSE-backed loans. While documentation requirements remain burdensome, average FICO scores among first-time buyers have actually trended lower.

**A Play on Inventory**

9. Opportunity Knocks After Builders Reduce Entry-Level Focus

12/06/16

A lack of affordable supply in the new-home market remains an opportunity for U.S. homebuilders. In the current industry cycle, builders have largely deemphasized the entry-level segment in favor of the higher-priced, wider-margin move-up market. While this strategy was favored over the last several years due to strong demand, mounting affordability concerns and market saturation may curb growth in this segment.

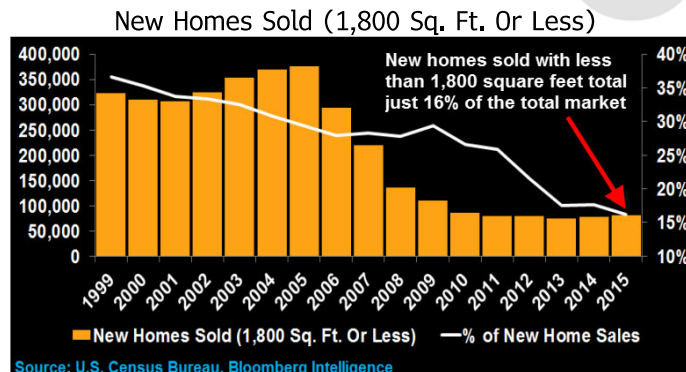


Peer Comparison: LGI Homes leads U.S. homebuilders with 99% exposure to the entry-level market. Beazer follows with about 60% exposure, KB Home (51%), D.R. Horton (45%), M/I Homes (39%), TRI Pointe (35%) and Century Communities (35%).

10. New Homes With 1,800 Square Feet or Less Fall to 16% of Market

12/06/16

Given new-home prices vary significantly by market (particularly coastal vs. inland markets), the square footage of those sold provides a good barometer of targeted buyer groups. New homes sold with 1,800 or less square feet (most representative of the entry-level segment) have fallen to 16% of total new-home sales, compared with the 15-year average of 27% and a high of 37% in 1999. This provides further evidence that a lack of inventory at lower price points has muted growth, particularly for first-time buyers.

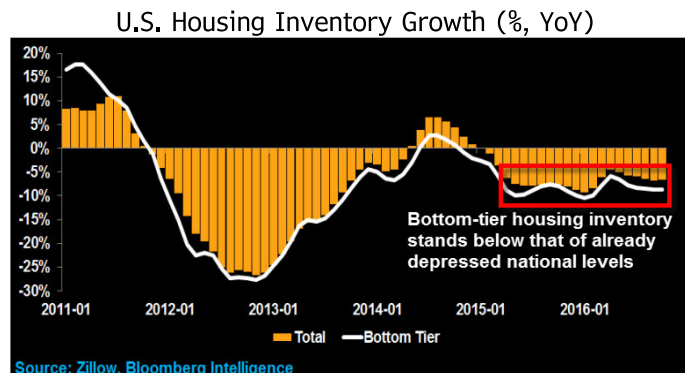


Companies Impacted: Behind the seventh-ranked Century Communities, NVR has 33% exposure to the entry-level market followed by PulteGroup (32%), Lennar (30%), William Lyon (26%), MDC (24%), Hovnanian (23%) and Taylor Morrison (22%).

11. Resale Market May Not Be an Outlet for Entry-Level Homebuyers

12/06/16

Though builders have de-emphasized the entry-level market, limiting inventory, the resale market may not be a sustainable alternative to meet future demand. A lot of the lower-cost inventory that came onto the market after the downturn was absorbed by investors and turned into rentals. Also, a significant portion of the negative-equity positions in the U.S. are concentrated at the lower end of the market. While home prices have increased significantly, negative equity remains a constraint to listings.

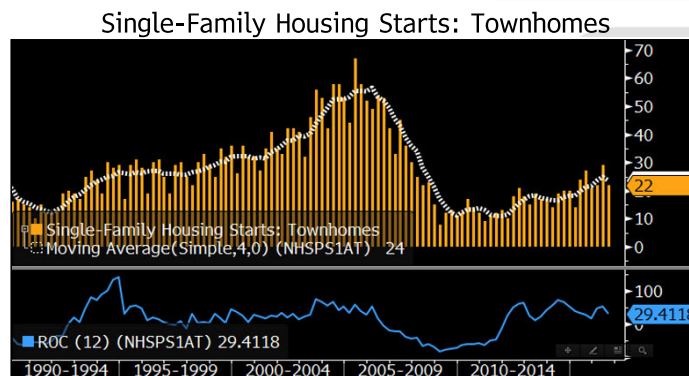


Inventory at the bottom tier of the U.S. housing market is declining at a faster pace than already depressed national levels, according to data from Zillow. This creates an opportunity for U.S. homebuilders catering to the market.

12. Higher-Density Construction Up in Support of Entry-Level Prices

12/06/16

One strategy builders are taking to combat higher land costs to reach more affordable price points is by developing more medium- and high-density neighborhoods though the building of townhomes. An increase in these types of dwellings may also be the result of the type of communities preferred by the younger population, including those that are within walking distance of work and amenities such as shops and restaurants.



Single-family attached (townhome) housing starts reached a post-recession high in 2016 and have been generating significant growth since 1Q12. Townhome construction increased 29% year-over-year in 3Q.

Risks And Challenges

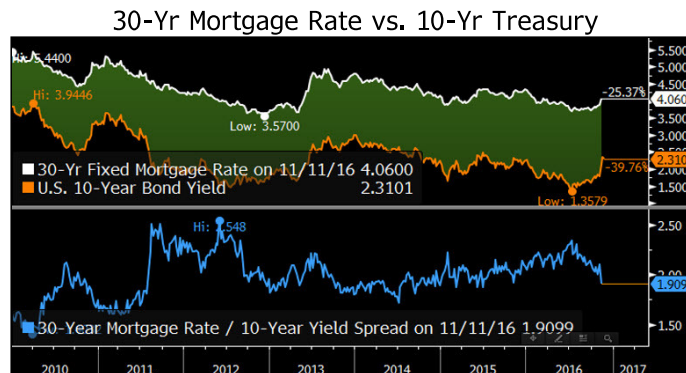
13. Rising Rates a Risk to Entry-Level Market on Buyer Sensitivity

12/06/16

The velocity of future rate increases will be key to the success of the entry-level housing market in 2017 and beyond, given this buyer group's keen sensitivity to monthly payments. First-time buyer affordability stands 23% above the long-term average, though will decline in coming months following the recent move in rates and may create a near-term headline risk. Continued wage

growth among the key 25-34 age cohort (up 6% in 2015) will be crucial in helping to offset the impact of rising rates.

Conversely, in a rising-rate environment, buyers may be more likely to trade down to smaller properties to make the economics of owning work. This may help to mitigate the negative impact that higher rates could have on certain buyers.

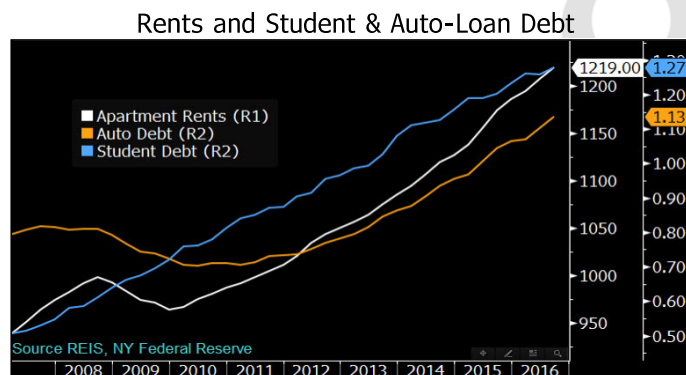


14. Debt Burden a Challenge for Would-Be First-Time Homebuyers

12/06/16

A heavy debt burden among the millennial population is among the factors limiting more robust household formations. The combination of sizable student and auto debt may be contributing to an inability to save for a down payment or to make monthly payments work. In addition, the rapid increase in rents across the U.S. has exacerbated these issues.

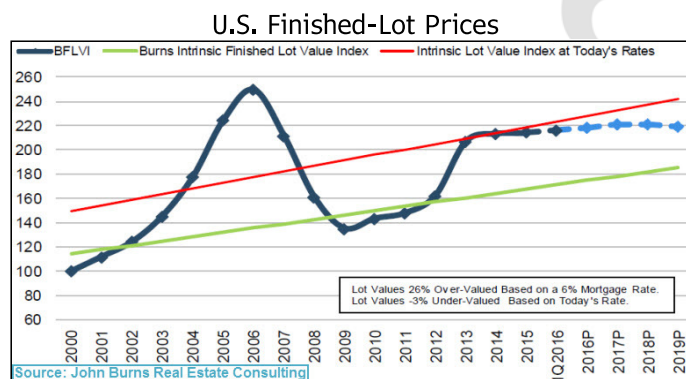
These challenges are implicitly reflected in current headship and homeownership rates among the younger age cohort. Even with no further improvement in headship rates, the scale of this population should fuel household growth.



15. Meteoric Rise in Land Prices a Challenge to Entry-Level Success

12/06/16

The steep rise in finished-lot prices this cycle has made it challenging for builders to operate in the entry-level market at an acceptable margin. As a result, much of the new single-family construction has been tailored toward the higher-priced move-up homebuyer segment. Lot prices tend to move fast in anticipation of increased demand (as was the case in 2012), though generally remain pretty sticky when demand begins to moderate. Finished-lot prices are expected to be roughly flat in coming years.



As a result of higher lot prices, builders have taken several strategies to meet lower price points, including moving into somewhat farther out locations where land tends to be cheaper, or increasing density to spread costs over a higher number of units.

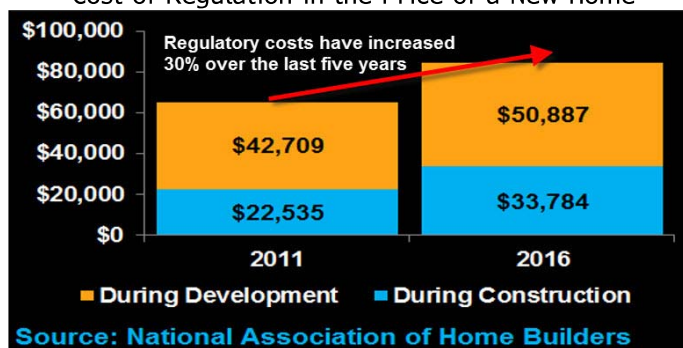
16. Increased Regulation Makes Buying Land Harder, Homes Costlier

11/30/16

Main Report [Homebuilder Considerations in a Trump Presidency](#)

The cost of government regulations in new single-family homes has increased about 30% since 2011, based on a study from the National Association of Home Builders. This equates to 24% of the average selling price of a home, ranging from 14-30%. Regulatory costs account for about 55% of the price of a finished lot, which has made it increasingly difficult for builders to hit internal hurdle rates on new deals while making it challenging for them to reach lower price points.

Cost of Regulation in the Price of a New Home



In addition, higher regulatory costs have resulted in builders constructing more-expensive homes, making ownership less affordable, particularly as income growth has significantly lagged the increases in regulatory costs and home prices.

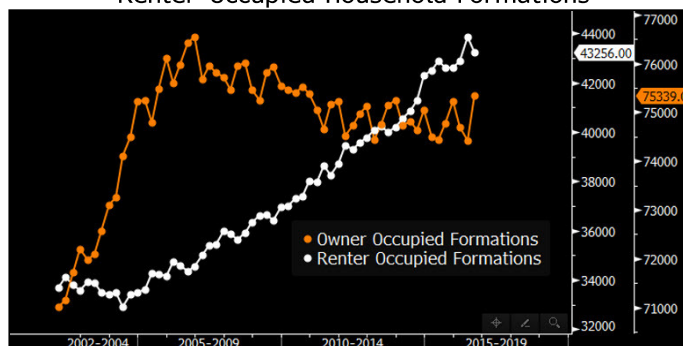
Not Ignoring Rentals

17. Select Public Builders Capitalizing on Strong Rental Opportunity

12/06/16

While the coming wave of millennials may provide a meaningful growth opportunity for builders in the entry-level market, traditional single-family builders have acknowledged that there's also an opportunity to capture demand in the for-rent segment, primarily through apartment construction. In fact, Lennar's multifamily venture was the fifth-largest apartment developer as of 2015. The company is operating a build-to-own model, which will generate a stable income stream from its properties.

Renter-Occupied Household Formations



Toll is also active in the apartment market, but to a lesser degree than Lennar, and its product is tailored toward the high end of the price spectrum. D.R. Horton has said it may test the rental model in communities it already owns, where land is zoned for such use.

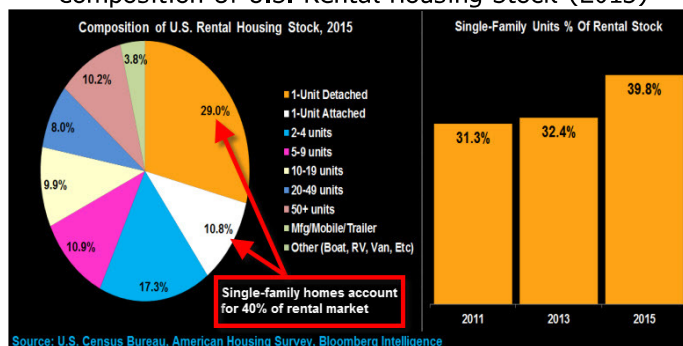
18. Single Family For-Rent Construction May Grow Alongside For-Sale

12/06/16

In addition to some builders targeting the influx of millennial households through apartment rentals, new single-family homes built for rent may provide an additional avenue of growth in pursuit of this demographic. Single-family homes account for 40% of the current U.S. housing rental stock, according to the Census' 2015 American Housing Survey. This shows that while home ownership rates have declined, there is still strong demand for single-family homes.

Lennar has tested the concept of single-family rentals in its Frontera subdivision at Pioneer Meadows in Sparks, Nevada. The company has noted good success in this business and intends to roll out the concept to other communities to gauge demand.

Composition Of U.S. Rental Housing Stock (2015)



Builder Strategies

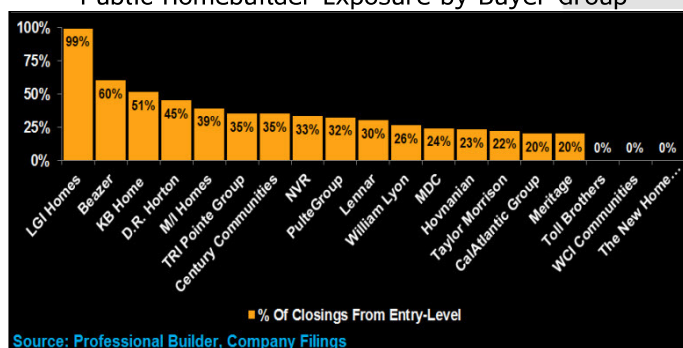
A Crowded Trade?

19. Homebuilders' Entry-Level Exposure to Expand After Move-Up Focus

12/06/16

Publicly traded homebuilders generate about 37% of closings from the entry-level homebuying segment compared with an average of 59% from the move-up (first- and second-time) segment. Exposure to the entry-level buyer has declined for a majority of the group over the last several years in favor of the higher-margin move-up segment. Still, numerous builders have expressed their intention to increase exposure to the underpenetrated entry-level market in coming years.

Public Homebuilder Exposure by Buyer Group



With more builders entering the market, overcrowding concerns have surfaced. While that remains to be seen, it's a scenario that would likely take years to play out. Additionally, it seems builders have adopted a diverse set of strategies in their pursuit of this segment.

D.R. Horton

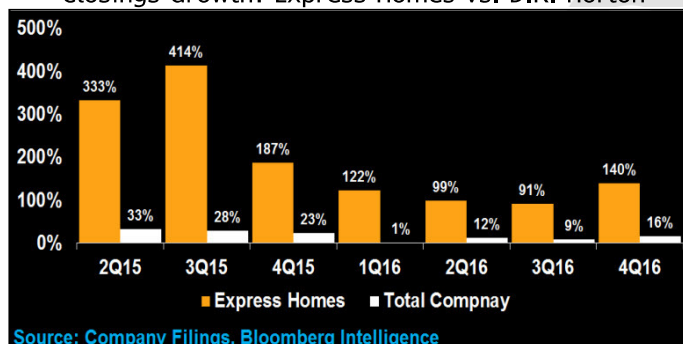
20. Entry-Level Express Homes Are Helping Fuel D.R. Horton Growth

11/22/16

Main Report [D.R. Horton Company Primer](#)

D.R. Horton's entry-level brand Express Homes has been a key growth driver. Horton gained an early-mover advantage as most other builders had until recently deemphasized the segment in favor of the move-up market. While Express may be a drag on pricing in the longer-term, the opposite has been true of late as the brand is introduced into higher-priced markets. At the same time, Horton's strong cost focus has resulted in stable margins despite Express becoming a bigger part of the business

Closings Growth: Express Homes vs. D.R. Horton



In fiscal 2016, D.R. Horton's Express Homes brand accounted for 27% of homes sold (from 18% in 2015) 26% of homes closed (from 15%) and 18% of home-sales revenue (from 10%). The average selling price of an Express Home increased 11% to \$204,600 in 2016 from \$185,000.

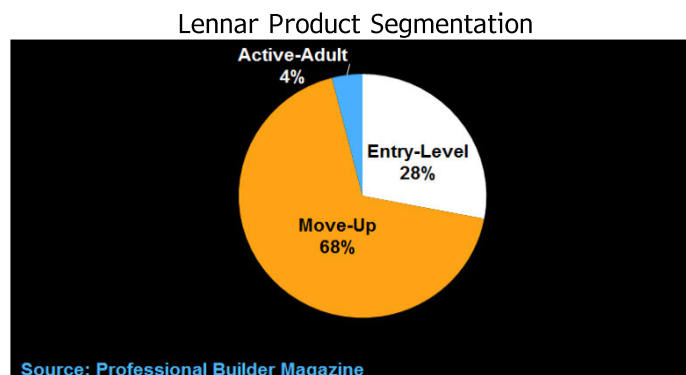
Lennar

21. Lennar to Up Ante on Entry-Level, Won't Enter Tertiary Markets

10/20/16

Main Report [Lennar Company Primer](#)

Lennar caters to move-up (68% of closings), entry-level (28%) and active-adult (4%) homebuyers. Like several of its peers, Lennar intends to increase its exposure to the entry-level market over the next several years. Still, its strategy calls for focusing on existing opportunities rather than buying land in tertiary markets. It will target more affordable markets including Texas, the Carolinas, Atlanta and Florida, where it expects a 10-20% increase in its entry-level exposure.



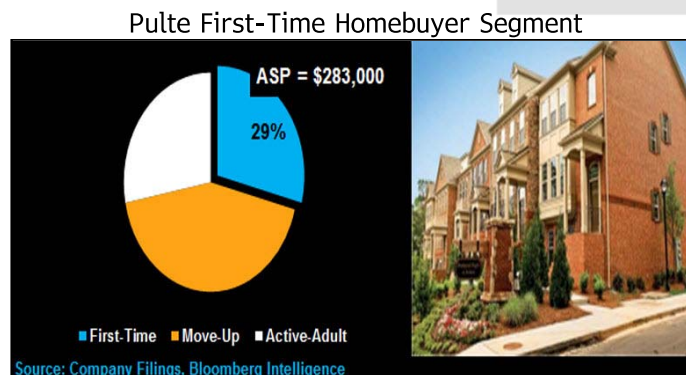
PulteGroup

22. "Close-In" Is Pulte's Offer for First-Time Homebuyers

11/25/16

Main Report [PulteGroup Company Primer](#)

Pulte intends to allocate a greater portion of capital to luring first-time buyers as demand improves and management seeks to diversify customer exposure. Unlike some peers, the company won't pursue land in further-out locations to accommodate lower price points, instead focusing on catering to millennials who prefer more urban, "closer-in" submarkets. The company said about 40% of its land approvals in 3Q were for communities targeting first-time buyers.



Pulte generated 29% of 3Q closings from the first-time homebuyer segment. The average selling price for its first-time buyer segment increased 8% year-over-year to \$283,000.

CalAtlantic Group

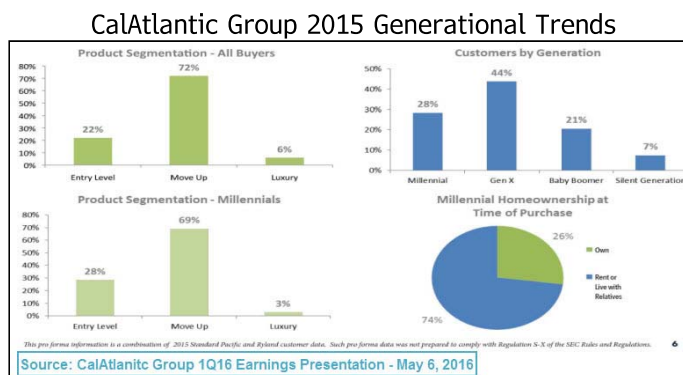
23. CalAtlantic's Millennial Buyers Prefer Move-Up Over Entry-Level

09/21/16

Main Report [CalAtlantic Group Company Primer](#)

A breakdown of CalAtlantic's homebuyers by generation shows 44% are Gen X'ers, 28% are millennials, 21% are Baby Boomers and 7% are from the Silent Generation. Interestingly, 65% of the company's millennial buyers are ages 30-34, supporting the notion that this generation may

become an increasing portion of industry demand as the leading edge of this group just turned 35 in 2015. Also of note is that 69% of millennial buyers purchased move-up homes, compared with 28% buying entry-level models.



Meritage Homes

24. Meritage's 'Entry-Level Plus' to Extend Segment to 40% of Sales

05/19/16

Main Report [Meritage Homes Company Primer](#)

Meritage is more aggressively targeting the entry-level buyer segment through its Entry-Level Plus product. The company plans to include more standard features than some of its competitors. As the primary focus will be to combat affordability, it intends to price its homes below FHA loan limits, with average selling prices of \$200,000-\$300,000, depending on the market. The strategy calls for purchasing land farther out from urban core areas and building higher-density communities.

Entry-Level Plus Product Overview

Meritage's differentiated entry-level plus offering

- Entry point for first-time buyers into a submarket
- Priced under FHA loan limits (\$300's BSP except CA)
- Sweet spot of 2,000 sf to 2,500 sf
 - A, B & C Submarkets
 - Product
 - SF Detached: 30' to 45'
 - Bungalows in the best locations
 - Townhomes with market-specific strategy
 - Deal Size: 100 to 200 lots
 - Absorptions: 4+ per month
- Appealing and efficient product
 - Expected to meet margin hurdles
 - Consistent with Meritage's green brand identity
 - Tailored production, sales and qualification are differentiated from move-up communities
- ~20% of Meritage communities in 2015 were entry-level/first-time homebuyer communities

LIFE. BUILT. BETTER.

Meritage Homes
Setting the standard for energy-efficient homes.

The entry-level push should result in higher sales absorptions, with the company targeting four sales in each community per month. Management anticipates the margins of this product to be similar to its underwriting standards of 20%, with the opportunity to generate improved operating leverage.

MDC Holdings

25. Expansion to Come for MDC's Entry-Level 'Seasons' Home Line

05/24/16

Main Report [MDC Holdings Company Primer](#)

Among MDC's key strategic initiatives is its focus on delivering a more affordable product. The company introduced its "Seasons" home line in 1Q, rolling it out in Colorado and Arizona. In addition to addressing affordability, MDC's aim is to reduce cycle times through more efficient design and construction and to increase inventory turnover to improve its return on assets.

MDC's Entry-Level 'Seasons' Product

2016 Focus: New Product / Affordability

SEASONS
Your dreams, within reach.
Fresh new floor plans.
Same signature quality.

Source: MDC Presentation - J.P. Morgan Homebuilding & Building Products Conference - May 17, 2016

Builder strategies on targeting the entry-level vary, with some focused on "shelter building" and others targeting a somewhat more

amenitized product. The typical specs on MDC's Season's line are 2-4 bedroom, 2-3 baths, 2 car garage at 1,400-1,950 square feet, which can be further customized by buyers.

William Lyon Homes

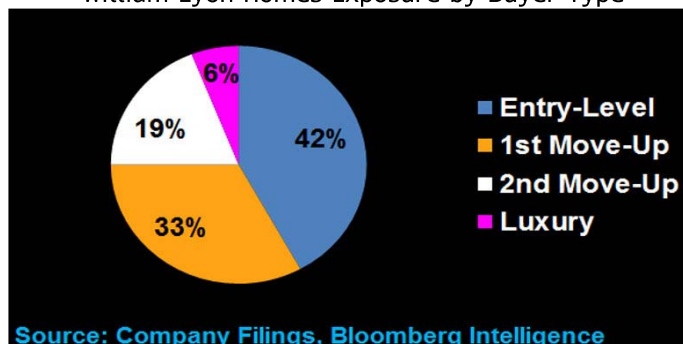
26. At 42% of Backlog, William Lyon's Entry-Level Exposure Is Strong

06/30/16

Main Report [William Lyon Homes Company Primer](#)

Based on its current backlog, William Lyon has 42% exposure to the entry-level homebuyer segment. The company's increasing exposure to the segment may be favorable amid the industry's need to combat stretched affordability in the move-up segment and improving trends at the entry level. The company also has 33% exposure to first-time move-up buyers, 19% to second-time ones and 6% exposure to the luxury segment. The company is actively pursuing land deals, which will help drive growth in the entry level.

William Lyon Homes Exposure by Buyer Type



LGI Homes

27. Playing to Entry-Level Homebuyers Differentiates LGI's Strategy

06/29/16

Main Report [LGI Homes Company Primer](#)

LGI Homes maintains the highest exposure to entry-level buyers, at 99%, according to Professional Builder. This sets it apart from industry peers that largely de-emphasized first-timers in favor of those moving up following the recession. LGI's entry-level strategy relies on purchasing lower-cost land in markets further from urban centers, though near transportation corridors. The company also maintains an efficient construction program with fewer floor plans and options.

Public Homebuilder Exposure by Buyer Group

	2015 Closings	Entry-Level	Move-Up	Active-Adult	Vacation
D.R. Horton	36,736	45%	55%	-	-
Lennar	24,292	30%	64%	6%	-
PulteGroup	17,127	32%	37%	31%	-
NVR	13,326	N/A	N/A	N/A	N/A
CalAtlantic Group	12,660	20%	79%	1%	-
KB Home	8,196	51%	35%	14%	-
Meritage	6,622	20%	76%	3%	1%
Taylor Morrison	6,311	22%	65%	13%	-
Toll Brothers	6,306	-	80%	15%	5%
Hovnanian	5,757	23%	65%	12%	-
Beazer	5,010	60%	40%	-	-
MDC	4,390	24%	76%	-	-
TRI Pointe Group	4,057	35%	65%	-	-
M/I Homes	3,883	39%	47%	11%	3%
LGI Homes	3,404	99%	1%	-	-
William Lyon	2,422	26%	74%	-	-
Century Communities	2,401	35%	65%	-	-
AV Homes	1,750	-	-	57%	-
WCI Communities	938	-	35%	51%	14%
UCP	701	N/A	N/A	N/A	N/A
The New Home Company	413	-	100%	-	-

Source: Professional Builder, Company Filings

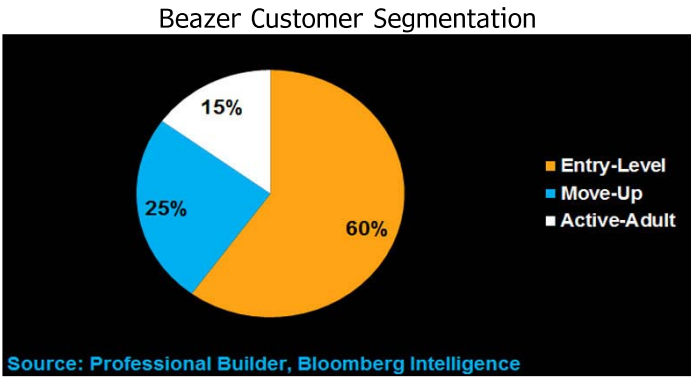
Beazer Homes

28. Beazer Diversifying From Large First-Time Homebuyer Business

11/30/16

Main Report [Beazer Homes USA Company Primer](#)

Beazer has a historically high exposure (about 60% of closings) to the entry-level homebuying segment, which may be favorable as affordability constraints, exacerbated by rising rates, push buyers to less expensive products. In addition, a large wave of millennial buyers is now approaching the first-time homebuying age. The company intends to increase its exposure to the active-adult market (15%), where demographic trends are expected to be favorable for many years.



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