SMEAD capital management

Missive

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High Expectations of Delayed Home Ownership

Dear fellow investors,

For the past two years, the housing narrative has been dominated by a single number: the thirty-year mortgage rate. With rates remaining high relative to pandemic-era lows, consensus expectations imply homebuilding is a cyclical business in retreat, waiting for the Federal Reserve to rescue it. In many ways, this view is understandable. A buyer who locked in a low rate is reluctant to sell, and a buyer shopping today faces a payment that looks unforgiving next to the one her neighbor enjoys. Put differently, the market has spent its energy debating the price of money and very little asking who is forming households, and what, precisely, they are willing to buy.

For more than a decade following the Great Financial Crisis, the United States built fewer homes than its population growth, household formation, and aging housing stock required. Builders and their lenders had been scarred by the bust, and land developers were wiped out in great numbers. Housing starts recovered slowly and remain below trend growth today. A shortage of this kind does not disappear because the mortgage rate fluctuates in a given quarter; it is cured only by construction, and construction is being constrained by the same high rates that frighten investors.

The demand side is where we have variant perceptions. While the affordability problem is real: rates, taxes, insurance, and down payments have made ownership expensive for many lower- and middle-income households, we observe the narrower cohort of married, college-educated, dual-income couples without children, who have adequate credit and income yet remain renters for partially non-economic reasons. Many of them will pay as much each month for a small city-center apartment as a suburban mortgage would cost at 6-7% rates and still decline the house. The decision is not rent versus buy. It is a walkable, flexible, experience-rich life versus a suburban or exurban home surrounded by identical structures, a Target Supercenter, a Home Depot, and perhaps even a Buc-ee's. Put in those terms, the rent is not the obstacle; the trade is.

Large builders solve affordability with cheap land and a standardized product. This manufacturing assembly line produces a product that is spacious, with spare bedrooms, a yard, and a two-car garage space. What the buyer surrenders is time, since a longer commute works as an implicit mortgage attached to the cheaper house, walkability, and identity, since the standardized subdivision offers little of it. For a childless couple, the extra bedrooms and the school district are excess capacity, a payment today for a contingent future use. The apartment's rewards are immediate and visible; the house's are deferred and conditional. Adding children on top of this is another expense that conflicts directly with their budget for (yet another) trip to Tuscany.

There is also a psychological element, one that we believe social media has amplified. Prior generations measured their standard of living against relatives, coworkers, and the neighbors visible from the front porch. Today's young adults measure theirs against an algorithm that overweights the exceptional: the best restaurant, the renovated kitchen, the vacation, the promotion. They compare those highlights with their own complete budget, commute, and ordinary weekdays, while the hidden inputs of parental help and "sponsorship" go unseen. Researchers such as Juliet Schor, Ethan Kross, and Philippe Verduyn have documented how reference groups and passive scrolling breed upward comparison and envy. Vacations are photogenic and rewarded with attention; the joys of home ownership as defined by property taxes, insurance, and HVAC replacements are not. Keeping up appearances means immediate gratification, while the long-run gains of ownership appear nearly invisible.

This creates a coordination problem the market under-appreciates, because houses and children are complements. A couple says it will buy when it is ready for children, and that it will have children once it is settled in the right house, and the apartment-and-delay equilibrium can persist for years. We believe shifting lifestyle choices therefore postpone household formation rather than abolish it altogether. The $64,000 question is if many of these couples will eventually buy when children arrive, when travel and "big dumb lines" lose their marginal appeal.

High Expectations of Delayed Home Ownership

NVR (NVR), D.R. Horton (DHI), and Lennar (LEN) share a characteristic that is easy to overlook in a debate about rates: each has changed the way it does business. NVR has long favored lot options over owning large amounts of land, keeping its capital employed low and its returns high. D.R. Horton has paired its scale and inventory discipline with a growing rental and lot-development business that diversifies its earnings. Lennar has also moved towards a land-light model, and is making the boldest bet on a housing start recovery by keeping volumes constant at the expense of near-term profitability. Each path differs slightly, but we believe each leads to a business that earns more per dollar invested and is far less vulnerable to the land write-downs that devastated the industry in the 2008 financial crisis.

The balance sheets tell the same story. The homebuilders of the last cycle entered the downturn burdened with debt and overpriced land, and many did not survive it. Today, the three companies we own carry modest leverage, hold substantial liquidity, and continue to repurchase shares at what we believe are attractive prices. In many ways, a company that can use a period of high rates to buy back stock, take share from weaker competitors, and secure land on favorable terms is being strengthened by the very conditions that are causing the industry to be shunned by investors today.

Housing starts may or may not return to trend, the birth rate may or may not recover, and mortgage rates may or may not decline. Regardless of these outcomes, we believe the through-cycle margins, the return on capital, and the balance sheet strength of NVR (NVR), D.R. Horton (DHI), and Lennar (LEN) are improving. In a market fixated on the price of money, we prefer to own the companies that are laser-focused on per-share value creation regardless of the state of the yield curve or the latest viral trend.

Play The Long Game,



William Keenan, CFA
Analyst

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