

Exchanges at Goldman Sachs

What's Ahead for the Housing Market

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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

Today we're going to be talking about a sector of the economy that affects us all - housing. The pandemic has ignited what can only be described as a home buying frenzy. Limited inventory, record low interest rates, and shifts in where we work have led to bidding wars and sky-high prices. But we're also starting 2022 with new uncertainties such as high and rising inflation and a new COVID variant that's slowing economic growth. So, are we entering an inflection point in the real estate market?

To help us make sense of the house market and what lies

ahead in 2022, I'm delighted to be joined by Doug Yearley, CEO of Toll Brothers, and Terry Hagerty, Co-Head of Home Building and Building Products Investment Banking at Goldman Sachs. Doug. Terry. Welcome to the program.

Doug Yearley: Thanks Allison. Thanks for having me.

Terry Hagerty: Thanks Allison.

Allison Nathan: Doug, as I've just mentioned, we've been in the midst of a white-hot housing market for the last two years where demand for new homes has, essentially, outpaced supply. First, talk about some of the drivers of this demand, as well as the challenges that have made it hard for new home construction to keep pace. And also, how Toll Brothers has navigated this environment.

Doug Yearley: Sure. So, if we go back to the winter of 2019/2020, the market was poised to really be strong. There had been ten years of undersupply of homes. Millennials, 70 million millennials, were just approaching their age of wanting to own their first house.

So, before COVID hit in March, we were enjoying the beginnings of a really good winter/spring selling season because of this imbalance between supply and demand over the last decade. The last ten years leading into COVID, this country built significantly less homes than each of the prior four decades. Then COVID hits. You know, Toll Brothers stock went from \$50 to \$13 in two weeks. Wall Street never thought we'd sell another home.

The first couple of months of the spring of '20 were slow, as everybody was absorbing this new normal. And you know, we're all at home. I remember walking the dog in suburban Philadelphia. Somebody came towards you walking a dog, you'd go to the other side of the street. We were scared. Nobody knew what was going on.

And then by May, just two months after we all went home, we started seeing these green shoots of significant demand coming out. Our sales teams, we stayed open, and in most of our markets we were allowed to continue to build. Some states shut down construction. And then through the summer of '20, all the way through to today, we have experienced the hottest housing market I have seen in my

32 years at Toll Brothers.

And it was driven by those fundamentals I mentioned going into COVID. Significant imbalance of supply and demand. Ten years of pent-up demand that hadn't come out. The millennials, now in their mid thirties buying their first home. Very low interest rates. In the spring of '20, the Fed dropped rates pretty dramatically. So, if you were a renter in the spring of '20 because rates were so low, you could own a home for the same monthly payment if you could scrape together 10, 20, \$30,000 for deposit.

When you look at the the monthly payment for the starter home market, that's what led. Starter home market led for those reasons. Just affordability was tremendous.

The resale markets got incredibly tight as very few people were putting their house on the market. They didn't want people coming through their homes, touring their homes in the midst of the worst of COVID. And so, the new homes compete, home builders all compete with presale inventory. That dried up. Prices went up dramatically on the resale market, which gave people equity in their home they never

thought they had. So, they were able to trade up to a newer, bigger home with more equity.

The stock market started performing well. So, those invested in the market were wealthier. And we had these tremendous migration patterns because you could work remotely. It became a perfect storm.

You know, it was a category five hurricane that turned into the perfect storm for our industry. For all these reasons the market just roared. It slowed a little. It's not frothy anymore. It's really good. Our price, as I mentioned on our earnings call back in December, our prices are up 25 percent year over year on average around the country.

There's cost pressure. So, that's obviously not dropping to all profitability. Lumber and other building materials are up significantly. Supply chain issues are acute, like nothing I've ever seen. But these have been really happy times for the builders. And it feels like it's going to continue. There's certainly pressure on rates. There's some pressure with affordability because prices are up. And the resale market is the tightest it's ever been on record. And

you just can't get a house. And so, that demand/supply imbalance is going to continue for a long time.

Allison Nathan: Let's talk a little bit more about that topic, affordability. The environment is changing as we've discussed. Inflation is rising. Interest rates are rising. And by extension, mortgage rates are likely moving higher. We're also beginning to see the cost of raw materials, I'm thinking lumber, rising again. So, what impact could these various factors have on home buying demand and home prices going forward? And how is that all impacting Toll's strategy?

Doug Yearley: Sure. So, we're not sure where rates will land through all this. But it's pretty clear they're going to be going up. So, even though the Fed hasn't officially had their first rate increase, which many believe could be as early as March-- and remember, the Fed rate is not the mortgage rate. The Fed rate is a very short-term rate. And the mortgage rate is a 30 year. There's a correlation. It's not always perfect. But there's certainly a correlation. But the rates have already moved. The mortgage rates have already moved in anticipation, I think, of what's coming.

We haven't seen any negative impact yet. I think rates, because of how hot the market is, will probably have to get into the mid 4 percent, almost another 100 basis points or 1 percent increase until you'd start seeing, I think, a bigger impact.

There's no question, it's just common sense, that when your price is up, whether it be 20 or 25 percent year over year, and mortgage rates are going to go up, there's pressure on affordability. Whether that pressure slows this market down or not, we'll have to see. Right now, there is so much more demand than there is available supply, available homes to buy, whether they be resale homes or new homes, that this is going to be very different than other cycles. It's going to take longer, it's going to take higher rates, it's going to take more price increases, I think, until we feel the affordability pressure.

And the migration trends, again, because of COVID, because of remote working, but also because of what I described pre COVID, which is just people are leaving the northeast. They're leaving California because of the cost of

living. The migration trends tend to be from very expensive states: New York, Massachusetts, New Jersey, Pennsylvania, California, where homes are more expensive. Taxes are higher. The cost of living is higher. Into more affordable places like Austin, Texas, Boise, Idaho, Reno, Nevada, Las Vegas, Phoenix, Denver, Florida, Charleston, Raleigh. You know, all these smile states.

So, there's less pressure on affordability when you're trading out of a more expensive area to a less expensive area. And so, I think that's another reason why it's going to take longer to feel the pressure.

Allison Nathan: Terry, let's bring you into the conversation. Doug has obviously given us some really great perspective. But from your seat in investment banking, how has the boom in the housing market affected strategic activity in the building products and home building sectors more broadly? And what's the range of CEOs that you speak to most focused on this year?

Terry Hagerty: Sure. So, the short answer is we've seen a meaningful increase in strategic activity in the home

building space, the building products space, and also with building products distributors. Folks across the sector issued over \$20 billion of equity in 2021, which was double the equity volume in both 2020 and 2019.

The driver of this activity was largely management teams across the sector experiencing record demands, and more importantly, feeling very good about investor interest in increasing their exposure to the housing sector. So, these things together, not surprisingly, made it feel like an optimal backdrop to take a business public through either a traditional IPO or through a SPAC merger.

We also saw home building and building products M&A increase 60 percent from 2020. In addition to just a very supportive housing environment and overall outlook, the reasons for this increase were some of the same drivers that have increased M&A more broadly across sectors. Specifically, high CEO confidence, inexpensive financing, and broad shareholder and board support for strategic transactions. And I would say this has been ubiquitous across every subsector of housing. And we continue to hear from CEOs an interest on the buy side of expanding and

growing your footprint, and for sellers recognizing that this is a very attractive evaluation environment, and it may be a good time to transact.

Allison Nathan: So, which sub-sectors? Are there sub-sectors where they've seen more activity than others? And do you expect that to continue this year? What are you seeing from the buyers and sellers?

Terry Hagerty: Sure. So, maybe I'll start with your second question first. In terms of what we're seeing from buyers and sellers, for sellers, it's really all about price. Sellers continue to feel good about the outlook for their businesses. And because of this, value expectations, really across all sub-sectors, have increased. For buyers, on the other hand, I would say it is two areas of focus. First, it's just the ability to get deals done. The regulatory environment has become more challenging, specifically for larger, transformative transactions. Additionally, buyers recognize that we are in an M&A market not dissimilar to the housing market right now. In a market like this, there is a balance between being aggressive enough to win competitive auctions, but also remaining disciplined on

price.

On your first question, the sub-sectors we expect to be active in 2022, I'm thinking we'll continue to see consolidation among building products manufacturers and building products distributors given that these sectors M&A has been a very effective tool for scaling businesses and creating shareholder value. In home building, on the other hand, while you will likely continue to see smaller, private deals, I'm not as confident that we'll see large, public to public transactions. The reason for this, without going into too much detail, is that when a home builder buys another home builder, they are not just buying the operations, they're also buying a large land portfolio. And given how land flows through financial statements, it typically takes about three years for the benefits of M&A to really show up in returns and earnings.

So, while I continue to believe that there is strategic logic for consolidation in the home building sectors, boards and management teams are going to need to be comfortable that the benefits may not be visible for several years. I would also love Doug's perspective on that as well.

Allison Nathan: Yeah, let's talk a little bit about the long-term trends. Doug, you've already begun to speak to some of them. But we do have people like Ivy Zelman, for anyone who doesn't know, the influential housing analyst who predicted the 2005 housing top talking about demographics, slowing population growth, that that, in itself, might be a big limit to demand over the medium and longer term. So, how are you thinking about some of these longer-term trends? And how do they affect your strategy?

Doug Yearley: We're very optimistic and positive on the longer-term business. The last ten years, as I mentioned, with the imbalance of supply and demand, those were good ten years. But it was steady and slow. It never got frothy. It never got overheated. So, there was no need for a correction.

Longer term, you have also, in addition to Ivy's analysis of babies being born, families being smaller, you've got to think about immigration. You've got to think about a second home market, particularly as more and more people are understanding the opportunity to work remotely.

They're focused on lifestyle issues and moving to certain areas that they have wanted to live. And you have to think about obsolescence. The existing housing stock in this country is aging. And it is slowly being replaced. Now, we're not in the tear down business. But I live in an area of suburban Philadelphia where with a small local builder there's a lot of that going on. So, there's more factors than just birth rate.

I'm not focused on the kids born today and when they're ready to buy a home in 30 years from now and there's less of them, what that market will look like. There are too many things that can change in the next 30 years where that's just not on the top of my list or even on my list. We look out three to five years because in some markets it takes that long to get land entitled. You know, the approval process is very tedious. And that's actually the biggest supply constraint of home building, is land. It's not readily available. You can't do whatever you want on a piece of land that you buy. The town will tell you what they may let you do if you jump through a bunch of hoops.

So, I think with the millennials, 70 million millennials

beginning to buy a home, and remember, they're now buying at 35 years old. I'm a boomer. I had my first house at 26 years old. I was a little bit early compared to my friends, but only by a year or two. And I was newly married, and we were poor at 26.

At 35, it's not unusual to have a dual income couple at 35 years old making \$200,000. Their first home is the Toll Brother's Three Series, which we now offer. You know, we don't just do the five and the seven BMW, we do the three. We have many, many clients who never thought that their first home would be a Toll Brothers home. But because they are older and wealthier and we have come down in price, it's a perfect match.

And so, as we continue to widen the net, and as these millennials just keep becoming of home owning age when they want to own a home, and then you've got 70 million boomers that are buying their second home or they're downsizing into those smile states I mentioned. So, I'm comfortable with the demographic trends, notwithstanding lower birth rates today. So, I think for the shorter term, call it three to five years, fundamentals are in place to continue

to see some great action.

Allison Nathan: Right. It's interesting that point you made about millennials. Because I think there is a perception, actually, that millennials have less purchasing power as a cohort. But that's not what you're seeing?

Doug Yearley: No.

Terry Hagerty: What's interesting on your millennial point, Allison, is I think a lot of people have talked about this generational wealth gap, which is certainly true. A fact that a lot of people don't talk about is that right now you have \$35 trillion of wealth in the US controlled by folks over the age of 70. You know, for the coming years, that wealth is going to be distributed to younger generations naturally through inheritance, investment, and just the general economic cycles. So, again, while the wealth gap is real, it does feel like something that remedies itself over time.

Allison Nathan: So, a discussion on so many trends, Doug. One of the other ones, a big trend that we can't seem

to get away from on this podcast is technological disruption. It's always coming up in all of our conversations. We have seen a lot of innovation in how buyers and sellers of homes are using technology. Talk about some of the opportunities and challenges for the home building sector from that perspective and how you're seeing that evolve.

Doug Yearley: Yeah. There is great opportunity for the industry because we've been very slow to adopt new technology. I was out in the field with my Timberland boots on and blue jeans working out of a trailer 30 years ago building houses. And they're built the same today. You've got 30 to 40 subcontractors. We don't own a hammer. We don't have plumbing companies and electrical companies. It's all subcontracted out. They're very local, mom and pop small businesses. And from when you dig the hole to pour the foundation to frame the house all the way through, it feels very similar today as it did back then.

And I think that will be slow to change. We don't have national traits. They're not all that sophisticated. There's technology that's hitting the industry rapidly when it comes

to construction management software and some of the back-office programming that is allowing us to be a bit more efficient in terms of how we schedule the trades, how we pay bills, how we run the job site.

You know, modular construction, where the house comes out on four or five flat bed 18 wheelers and gets put together in a week, that hasn't yet really caught on, particularly with the bigger homes that we build that are more custom. There is some opportunity for offsite panel and truss manufacturing, which is the wall panels and the roof trusses. In fact, Toll Brothers, we have our own plants that do some of that.

You know, Lennar recently announced that they're going to a 3D printing community in Texas where the homes are going to be printed with concrete out of the 3D printing technology. And that's pretty exciting to see how that works out.

Robotics, where what we call closed wall systems, where a traditional panel that comes out is just the wood. Then you have to put the plumbing and the HVAC and the electric

wires through that wood on the job site. Put the insulation and the drywall on. If you can put that all together where it's a closed panel and you literally clip together panel to panel an electric clip, an HVAC clip, plumbing pipes that clip. You know, there's talk of that. So far, those companies have failed because they're just more expensive. And it's so hard for transportation to get all these components from the factory to the job site.

As lumber got really expensive, we started moving to steel and doing light gauge steel framing. Different trade base. You know, the wood framer isn't ready to jump into the steel framing. It's completely different.

So, it's slow to come. FinTech, financial technology, the mortgage company, the software programs, the title company, that's moving pretty well. PropTech as we call it, property technology, which is smart home technology and how it operates and all the related gadgets and things that we can do, you know, there's a lot of opportunity. But back to where I started. When you walk a job site and watch the plumber in the mud plumbing the house and there's only five employees in a small company and he's happy working

on two or three communities on only the northern suburbs of Philadelphia, that's the business, unfortunately. And so, it's been harder for us to bring these efficiencies through technology. But we're not giving up. It has to change. It will change. But it is a difficult industry to flip the switch on.

Terry Hagerty: I agree with Doug in terms of there is a lot of opportunity for technological innovation, certainly in the home building process. In addition to some of the challenges that Doug mentioned, another thing that has historically limited growth of technology in this sector has been limited appetite from venture investors to fund early-stage businesses focused on changing the way homes are built. And this is because most of these early-stage companies are at their core manufacturers who require a lot of capital in order to reach scale and profitability. And investors have had a preference for more predictable, asset-light businesses.

I do think this funding dynamic is beginning to change. And as these businesses raise capital, they'll be able to to scale more quickly and ultimately drive more adoption.

Allison Nathan: We have covered so much territory, all very interesting. And again, it resonates with all of us, as a lot of us are living and breathing the home market. Terry and Doug, what are both of your expectations for strategic in capital markets activity going forward?

Doug Yearley: Well, I think, and you know we work very closely with Terry when we think about growth, M&A. We buy one to two small, local builders a year. We call it bolt on acquisition. It just bolts onto what we're already doing to either enter a new market or to just get bigger in an existing market.

I don't know when it comes, but there is opportunity in this industry for consolidation public to public. There are a lot of builders. There are a lot of public builders. There are some large private builders. And we overlap a lot in what we do. And it's a lot harder than when regional banks merge or national banks merge. But I think at some point you're going to see more of that. And so, I think that's going to accelerate growth for certain companies. And so, we'll keep our eye-- there's nothing going on now. We're always in the conversation, as the other publics would be, and

there have been very few large public to public mergers. And some have succeeded. And some have not. So, I think we need to keep our eye on that.

Terry Hagerty: And we expect 2022 to be another robust year. On the equity side, we're still early in the year. We've already had one IPO announced in the sector, as well as several equity issuances completed. As it relates to M&A, there continues to be a high level of strategic dialogue between targets and potential acquirers. There are, of course, various known and unknown risks that could halt this activity. But based on what we are seeing today, we expect it to be another busy year.

Allison Nathan: Doug and Terry, thanks so much for sharing all of these insights. We are all going to sit and watch and see what happens with the home market ahead. Thanks again for joining us today.

Doug Yearley: Thanks, Allison.

Terry Hagerty: Thank you.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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