Credit Research Initiative
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Weekly Credit Brief April 21 - April 27

US homebuilders remain resilient despite a drop in new home sales

by Dexter Tan

Last Thursday, figures from the US Commerce Department showed that sales of newly built homes declined 11.4% month-on-month in March to a seasonally adjusted annual rate of 481,000. However, February's figure was revised upward to 543,000, which was the strongest month for new home sales in seven years. A number of listed homebuilders also reported earnings during the week, including the largest US residential developer – Dr Horton Inc. (Dr H) and the third largest homebuilder – PulteGroup Inc. (PG). The results were very positive, suggesting that the US housing market is turning into a bright spot for investors after a weak performance last year.

Reflecting the improvement in credit quality, the RMI aggregate 1-year probability of default (RMI PD), which is a simple median of RMI PDs for 13 large listed homebuilders, declined significantly in recent months. RMI's aggregate 1-year likelihood of insolvency decreased from 21bps in October last year to 3.7bps in March. The sector's overall market capitalization increased from USD 23bn to nearly USD 29bn last month, on rising home-builder confidence which reached a nine year high in September 2014. Moreover, the credit profiles of Dr Horton and PulteGroup have strengthened over time as the US housing market continues to recover at a gradual pace.

Many builders have reported upbeat revenues so far this year. Dr Horton announced healthy Q1 earnings backed by 33% YoY sales momentum during the quarter. The company's entry level Express Homes and higher-end Emerald brands operating divisions continued to sell at a solid pace with home sales in Texas continuing to register an upward trend in Q1. M/I Homes Inc. said Q1 sales increased 13% to 1108 homes while Meritage Homes grew their top-line by 27% YoY. During the earnings call last week, PulteGroup Inc. delivered an optimistic 2015 outlook for the company, stating that home sales have improved thanks to low interest rates, low inventory of available homes, strong job and wage growth.

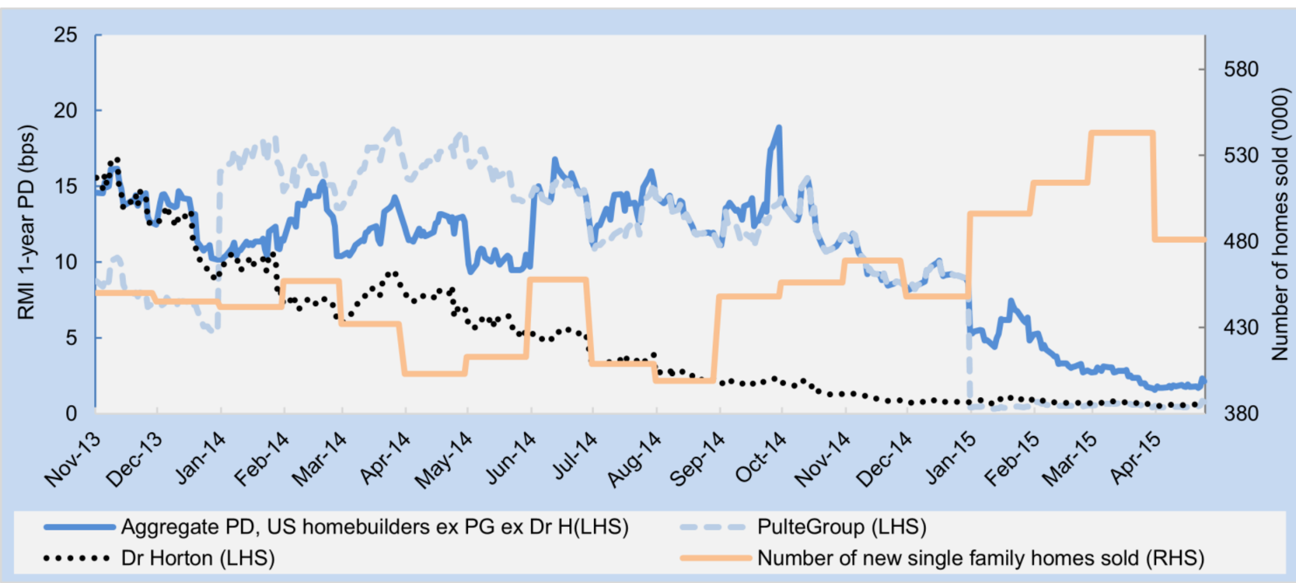

Figure 1: RMI PDs for US homebuilders vs sales of new single family homes. Source: *Risk Management Institute, Bloomberg, US Census Bureau*

		Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
RMI distance-to-default	Sector median ex PG ex Dr H	3.69	3.66	3.68	3.38	4.62	4.92
	Dr Horton	3.98	4.13	5.04	5.80	6.67	6.85
	PulteGroup	3.17	3.19	3.68	3.58	7.74	7.29
Market cap (USD mn)	Sector total ex PG ex Dr H	26,274	25,515	26,721	23,055	25,430	28,994
	Dr Horton	7,218	7,005	7,995	7,479	9,239	10,407
	PulteGroup	7,803	7,315	7,634	6,639	7,957	8,144
RMI 1-year PD (bps)	Sector median ex PG ex Dr H	10.17	12.29	12.48	20.18	5.69	3.71
	Dr Horton	9.44	8.16	3.33	1.98	0.78	0.57
	PulteGroup	15.97	16.37	11.22	14.21	0.42	0.50

Table 1: RMI risk metrics for homebuilders. Source: *Risk Management Institute, Bloomberg*

Consistent profits, a prudent land acquisition strategy and strong liquidity position have lowered Dr Horton's credit risk profile over the past 1.5 years. As shown in Table 2, in Q4 2013, return on invested capital rose above most peers on steady home demand and lower costs due to warranty and construction defect claims, even as the company continued to hold pricing in many of its markets. In the subsequent quarter, the largest homebuilder managed to raise revenue on a QoQ basis despite the poor weather that affected sales of its competitors. A broad and diversified portfolio and aggressive execution strategy helped keep the firm ahead of its peers. Being the largest player in the market, the company likely had better access to skilled subcontractors, higher negotiating power with suppliers and first contact to attractive land deals. During 2014, the company also benefitted from the increased market share in many of their business segments as they expanded their operations in the luxury and affordable homes segment.

Dr Horton and PulteGroup Inc. both have above average capabilities to generate cash to service their liabilities in all quarters, as evident from their high funds from operations to total debt ratios. Larger homebuilders have a competitive advantage over other firms through their abilities to leverage economies of scale, access to more reliable cost of financing through capital markets. The average homebuilders have a relatively higher proportion of debt to total capital as they do not have the strong balance sheets and wide access to low cost capital that larger companies, such as Dr Horton enjoy.

Homebuilders are more confident that better times are ahead. Residential estates are affordable, sales volume are increasing, small businesses and consumer confidence remain elevated, and the job market is growing. Potential home owners are taking the plunge to lock in their 30 year fixed mortgage rates at a low level of 3.7%. The prospect of the Federal Reserve raising benchmark rates this year has propelled home purchases as buyers do not want to miss out on low mortgage rates.

		Q4 13	Q1 14	Q2 14	Q3 14	Q4 14
Revenue (USD mn)	Sector total ex PG ex Dr H	7318	5191	6668	7575	9109
	Dr Horton	1671	1735	2147	2472	2303
	PulteGroup	1655	1119	1286	1595	1823
Funds from operations / total debt (%)	Sector average ex PG ex Dr H	5.9%	6.8%	6.7%	6.7%	7.0%
	Dr Horton	16.0%	16.0%	14.5%	12.6%	12.6%
	PulteGroup	15.2%	18.6%	18.0%	19.9%	18.4%
T12M Return on invested capital (%)	Sector average ex PG ex Dr H	5.8%	8.8%	4.7%	4.7%	7.9%
	Dr Horton	7.0%	6.7%	6.2%	6.3%	6.3%
	PulteGroup*	7.4%	7.6%	7.7%	7.1%	7.1%
Total debt / capital (%)	Sector average ex PG ex Dr H	74.7%	73.2%	75.3%	75.3%	74.9%
	Dr Horton	63.2%	62.7%	58.5%	60.2%	58.1%
	PulteGroup	59.1%	55.2%	57.6%	58.1%	56.4%

Table 2: Credit related indicators for homebuilders. * We subtracted USD 2107mn from PG's T12M net income due to an extraordinary gain from a reversal of deferred tax assets tied to losses during the housing crash in Q3 2013. Source: *Bloomberg*

Credit News

Japan insurers pile into US debt

Apr 26. Japanese life insurers—some of the world's largest institutional investors—plan to keep pouring money into US debt as a list of countries able to meet their thirst for yield shrinks. US government bonds still have a relatively higher yield compared with German and Japanese government bonds. The continued decline in JGB yields—due to the Bank of Japan's massive bond buying program and slower global growth prospects—is driving insurers to secure the yields by foreign bonds. (WSJ)

S&P downgrades Puerto Rico debt to 'CCC+' from 'B'

Apr 24. Standard & Poor's said on Apr 24 that it had downgraded Puerto Rico's general obligation debt even further into junk territory, from a B rating down to a CCC plus grade, which means four notches above the lowest possible grade of "default". The downgrade was based on the view that the US commonwealth's access to markets has further weakened, and that political problems, particularly a lack of consensus on elements of the 2016 budget, could further worsen fiscal pressure on the territory. (Reuters)

Debt builds in China stock rally

Apr 23. Margin lending has more than tripled in the past year to a record USD 274.6bn, according to WIND Information Co., a provider of financial data. Along with several rounds of monetary easing from China's central bank in recent months, margin lending has helped stoke an explosive market. The Shanghai Composite Index rose 53% last year and another 36% this year. However, the concerns about market stability also are rising now. (WSJ)

Tesco slides to record GBP 6.4bn annual loss

Apr 22. The retailer Tesco said on Apr 22 that GBP 7bn of write-downs and charges - primarily GBP 4.7bn for the slump in the value of its mainly UK store estate - pushed it into the red in the year ending in February. The pre-tax loss was GBP 6.4bn, the worst performance in Tesco's near 100-year history, and it was said to overstate previous profits. The loss is the biggest for a British retailer and one of the largest in British corporate history for a non-bank company, even worse than the most pessimistic analyst expectations. (FT)

China sees first bond default by state firm with Tianwei

Apr 21. Baoding Tianwei Group Co., the unit of central government-owned China South Industries Group Corp., said it will fail to pay CNY 85.5mn interest on an onshore bond due Tuesday. This Chinese power-transformer maker became the country's first state-owned company to default on an onshore bond, signaling the government's willingness to let market forces decide an enterprise's fate. (Bloomberg)

Fortescue hit with second credit rating downgrade (The Australian)

Creditors, Caesars spar over control of casino bankruptcy (Reuters)

Debt piles up in Asia, threatening growth (WSJ)

Regulatory Updates

Deutsche Bank first-quarter profit falls by half as legal charges bite

Apr 26. Deutsche Bank's net profit sank to EUR 559mn (USD 608mn) in Q1 2015, a greater-than-expected drop as hefty legal charges eroded gains in investment banking revenue. Group revenue rose to a near record EUR 10.4bn, of which almost half came from the investment bank, but its pre-tax contribution fell by more than half due to litigation and regulatory expenses and currency swings. Deutsche on Apr 24 announced a new strategic plan including the sale of its Postbank retail chain and additional paring back in investment banking. (Reuters)

EU to delay swaps capital rule amid US clearing talks

Apr 24. The European Union is set to postpone the start of stricter bank capital rules for some swaps trades as it negotiates with the US to resolve a regulatory clash. The deadline of the start date of the rules was supposed to be mid-June and may be pushed back to mid-December. The delay is linked to ongoing negotiations between the EU and the US over the scope of their rules for the USD 691tn market for swaps and other over-the-counter derivatives, as regulators seek to plug loopholes exposed by the 2008 financial crisis. (Bloomberg)

China's IPO rules to ease under new registration system

Apr 21. Beijing has started the countdown to the establishment of a more relaxed initial public offering (IPO) system, with a so-called registration mechanism likely to be introduced by the end of this year. The National People's Congress (NPC) began reviewing amendments to the securities law on Monday, paving the way for the China Securities Regulatory Commission (CSRC) to revamp an IPO system currently dependent on official approvals. The existing securities law stipulates that IPOs cannot be launched on the mainland without an official green light. (SCMP)

MAS issues revised notices on anti-money laundering (Channel NewsAsia)

HSBC looks at moving HQ from Britain as tax and regulations bite (Reuters)

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