Building Scale and Profits

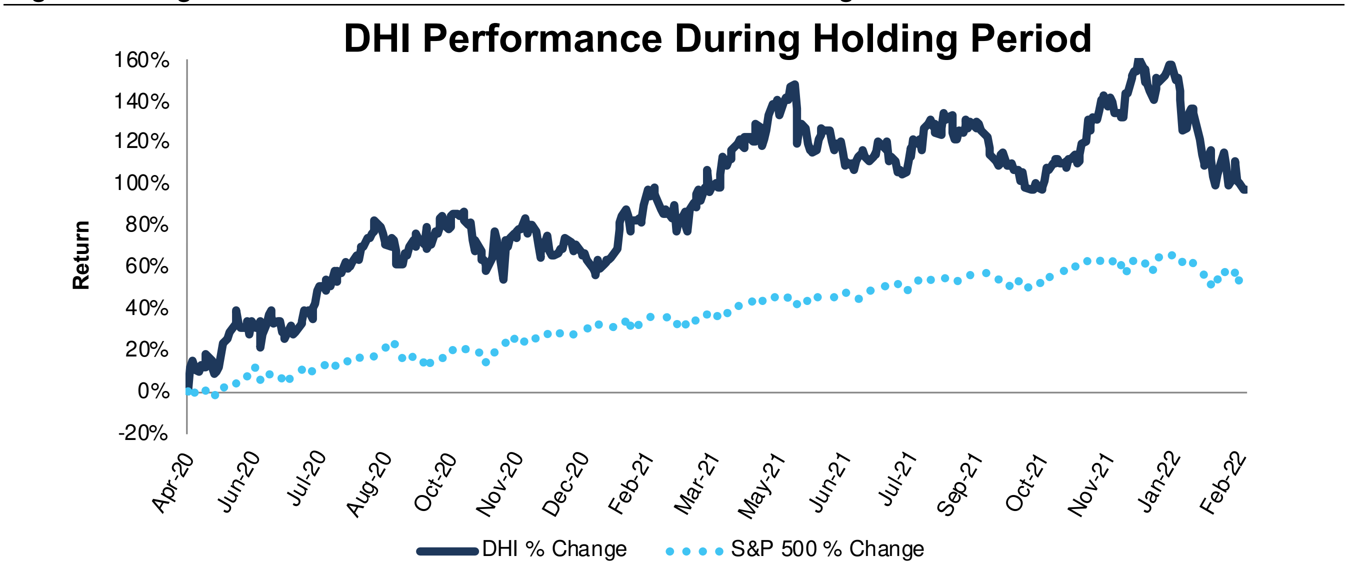
We made D.R. Horton Inc. (DHI: $85/share) a Long Idea in April 2020, as part of our "See Through the Dip" thesis. Since then, the stock is up 101% compared to a 55% gain for the S&P 500. Despite its large outperformance, the stock could be worth $181+/share – another 100%+ upside. Our most recent report on D.R. Horton, from March 2021, is here.

We leverage more reliable fundamental data, as proven in The Journal of Financial Economics[1], with qualitative research to pick this Long Idea. Our proprietary research provides a new source of alpha.

D.R. Horton Is Loaded With Upside

- D.R. Horton has been the largest homebuilder (by total closings) in the U.S. since 2002.
- Demand for housing will persist in the near term because the national housing supply remains below its historical average.
- The willingness for government to intervene in housing finance mitigates the risk of rising interest rates.
- Despite rising labor and material costs across the homebuilding industry, D.R. Horton is realizing greater scale, which helps protect its margins.
- The stock has 118% upside with moderate profit growth.

Figure 1: Long Idea Performance: From Date of Publication Through 2/15/2022



Sources: New Constructs, LLC and company filings

What's Working

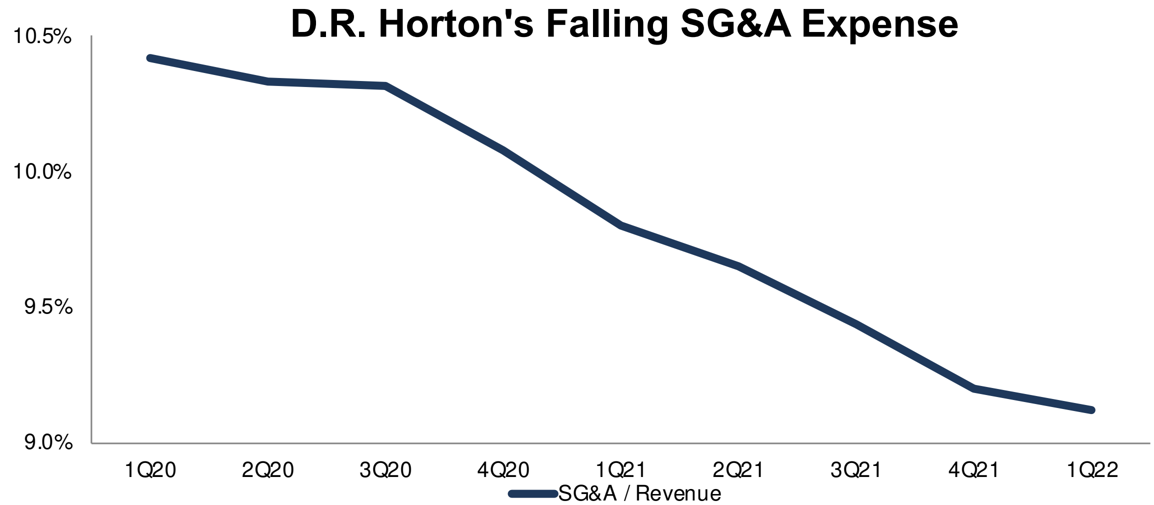
Strong Fiscal 1Q22 Performance: D.R. Horton continues to grow revenue and profits as strong housing demand provides a significant tailwind. The company's fiscal 1Q22 (FYE is 9/30) revenue rose 19% year-over-year (YoY), in large part due to the average closing price of homes sold rising 19% over the same time. Core Earnings rose 47% YoY from $796 million in fiscal 1Q21 to $1.2 billion in fiscal 1Q22.

[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

Improving Profitability: Longer term, the company's net operating profit after tax (NOPAT) margin rose from 7% in fiscal 2016 to 16% over the trailing-twelve-month (TTM) period, while invested capital turns rose from 1.0 to 1.4. Rising NOPAT margins and invested capital turns drive D.R. Horton's return on invested capital (ROIC) from 7% in fiscal 2016 to 22% TTM.

Scale Is Driving Efficiencies: D.R. Horton's net sales orders in fiscal 1Q20 were 13,126. In fiscal 1Q22, net sales orders rose 64% to 21,522. Expanding operations are driving economies of scale, as evidenced by TTM Selling, General, and Administrative expense as a percentage of TTM revenue falling from 10.4% in fiscal 1Q20 to 9.1% in fiscal 1Q22.

Figure 2: TTM Selling, General & Administrative Expense / Revenue: 1Q20 – 1Q22



Sources: New Constructs, LLC and company filings

Positioned for Long-term Growth: The average number of single-family housing starts grew from 1.2 million in 2017 to nearly 1.6 million in 2021. The National Association of Homebuilders expects housing starts in 2022 and 2023 to grow above 2021 levels. With an average closing price of $361,800 in fiscal 1Q22, the company primarily targets entry-level buyers, a segment of the market where a significant backlog of demand remains.

The company plans to meet the strong demand for housing by increasing its inventory to 54,800 homes in fiscal 1Q22, up 30% from the prior year.

Looking ahead, D.R. Horton is positioned to grow profits as it expects to close ~91,000 homes in fiscal 2022, an 11% increase over fiscal 2021.

What's Not Working

Slowing Growth: The company's net sales orders growth of 5% YoY in fiscal 1Q22 is far less than the 56% YoY growth in fiscal 1Q21. Nobody expected the company to match growth rates achieved at the time demand was surging, but supply chain disruptions also slowed net sales orders. However, despite the slowdown in fiscal 2021, the company is guiding for "double-digit volume growth in fiscal 2022".

Rising Material and Labor Costs: While the company's cost of sales per square foot rose 2.9% quarter-over-quarter (QoQ) in fiscal 1Q22, its revenue rose 3.4% QoQ. Even though material and labor costs are rising, the company has successfully passed them through to customers, a trend we expect to continue given the strength of the current housing market.

While labor and supply chain problems have negatively impacted the company's operations, D.R. Horton can leverage its industry-leading scale to better manage these industry-wide problems. As a result, we expect the company to take even more market share from builders with less scale and operational efficiency.

Rising Interest Rates: It is no secret that higher rates make housing less affordable for customers. However, D.R. Horton's large position in the more-affordable, entry-level segment of the housing market means it can benefit from consumers moving down-market to find affordability.

Despite the recent rise in interest rates, rates are still historically low, and new home demand is still historically strong. However, if rising interest rates begin to make housing unaffordable for too many people, government intervention is likely to expand current assistance programs or even introduce new legislation to encourage more affordable housing. As an entry-level home builder, DHI will definitely benefit from any government intervention to support home ownership and, therefore, homebuilding.

D.R. Horton Is Priced For a Permanent 60% Profit Decline

D.R. Horton's price-to-economic book value (PEBV) ratio of 0.4 means the stock is priced for profits to fall, permanently, by 60% from TTM levels. Below, we use our reverse discounted cash flow (DCF) model to analyze the expectations for future growth in cash flows baked into a couple of stock price scenarios for D.R. Horton.

In the first scenario, we assume D.R. Horton's:

- NOPAT margin falls to 8% (20-year average vs. 16% TTM) from fiscal 2022 – 2031, and
- revenue falls by 2% (vs. consensus CAGR of +17% for fiscal 2022 – 2023) compounded annually from fiscal 2022 – 2031.

In this scenario, D.R. Horton's NOPAT falls 8% compounded annually over the next decade and the stock is worth $83/share today – equal to the current price. For reference, D.R. Horton grew NOPAT by 36% compounded annually over the past 10 years.

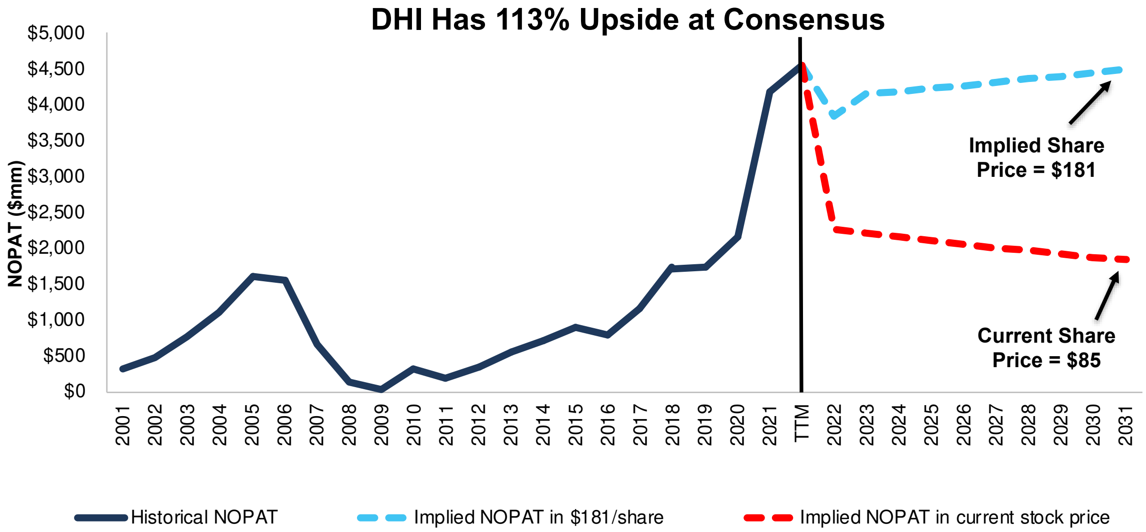
D.R. Horton's Shares Could Reach $181 or Higher

If we assume D.R. Horton's:

- NOPAT margin falls to 11% (five-year average) from fiscal 2022 – 2031,
- revenue grows at a 17% CAGR from fiscal 2022 – 2023 (equal to consensus), and
- revenue grows by 1% compounded annually from fiscal 2024 – 2031, then

the stock is worth $181/share today – 113% above the current price. In this scenario, D.R. Horton's NOPAT in fiscal 2031 is still 1% below TTM levels. Should D.R. Horton grow NOPAT more in line with historical growth rates, the stock has even more upside.

Figure 3: D.R. Horton's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings

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Disclosure: David Trainer owns DHI. David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, sector, style, or theme.

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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