Industry Top Trends Update

# Homebuilders and Developers

## Positive sector outlook moderates in 2H22

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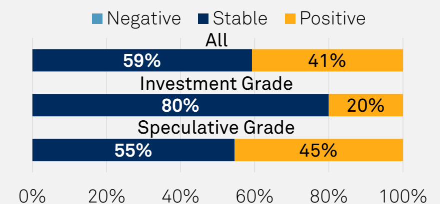
### Outlook Distribution

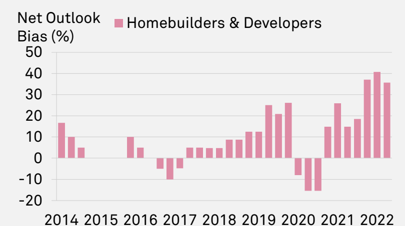



### Ratings Statistics (YTD)*

| | IG | SG | All |
|---|---|---|---|
| **Ratings** | 5 | 22 | 27 |
| **Downgrades** | 0 | 0 | 0 |
| **Upgrades** | 0 | 1 | 1 |

Ratings data as of end-June 2022. * Year-to-date

### Ratings Outlook Net Bias




## What's changed?

**Mortgage rates have increased to over 5% from below 3% in early 2022**. Coupled with home price growth, this has led to substantial increases in the monthly payments on new mortgages, which could further lower affordability, particularly for first-time homebuyers.

**Worsening affordability.** Thus far the impact of lower affordability is mostly anecdotal, with incentives and order cancellations starting to tick up. In the second half of the year we expect most rated builders to close on their swelling backlogs so as to avoid deep markdowns and lost sales.

**Need to increase inventories.** The lack of home inventories has been the key driver of home-price inflation these past 12-18 months. We think spending on inventories will be materially higher in 2022 than last year, mainly to complete homes already on order (i.e., backlog), and for future growth, and in most cases funded via internally generated cash.

## What to look out for?

**High inflation exacerbating recession concerns.** Rising mortgage rates along with weaker economic growth could slow demand for homes in the next year, particularly for prospective first-time homebuyers as affordability worsens.

**Slowing price growth and rising costs could limit margin expansion in 2022.** As mortgage rates rise from record lows, this could slow the price growth that has sustained margins amid higher costs and an industrywide shift to lower price points. In most cases, added incentives are often more effective than price cuts.

**A less-positive sector outlook**. With higher mortgage rates and probability of recession, we expect the positive operating momentum for homebuilders to ease, which could limit the number of possible upgrades in the second half.

## What if there's a recession?

**Weaker demand relative to current levels.** With slower economic growth, we would expect sales and deliveries to slow. However, supply constraints are enough to maintain good demand characteristics overall.

**Deteriorating profitability.** We would expect lower EBITDA margins, which are already at peak levels, as home prices moderate and incentives increase amid continued higher labor, land, and material costs.

**Credit buffer provides some protection.** Financial discipline before and during the pandemic has yielded stronger ratios and a widening credit buffer, indicating improved credit quality. We would need to see a substantial deterioration in EBITDA to reduce that credit buffer before taking any negative rating actions.

## Latest Related Research

- Real Estate Monitor: Slowing Growth Lies Ahead For U.S. Real Estate Companies, June 8, 2022