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**KELLY EVANS, CNBC:**

Welcome back to The Exchange. U.S. housing starts surged more than expected last month as mortgage rates fell back from their highs. Construction of new homes rose by nearly 15 percent to an annualized pace of just over one and a half million. That's the highest level since May. And that in turn is boosting the builder stocks today, including Meritage, Toll and DR Horton. And those three names are among my next guest’s top picks for 2024. He says they'll be able to weather a strong spring selling season. For more, let's bring in Joe Ahlersmeyer. He's a research analyst at Deutsche Bank. Joe, welcome. It's good to see you again. And first of all, do you mean a strong kind of traditional spring selling season could in a way be a headwind for the home builders?

**JOE AHLERSMEYER, DEUTSCHE BANK:**

Thanks for having me, Kelly. Nice to be here. What I'm really talking about is if you look at this starts number today, look, I would be really excited to be talking about this type of number in April or May, but this is a seasonally unimportant time of year really for builders. We're in November, really talking about a number that is lower on a monthly basis than what we actually were building to in May, June and July. And if we build to the same number next month, we're actually going to see a 9 percent sequential increase. That's how funky this data actually gets. So I'd caution people just to kind of look at this as not necessarily indicative of a really big acceleration in starts simply because rates are coming down. I would think of it more as builders are putting inventory in the ground preparing for a more normal spring selling season. And that's going to drive really strong cash flow in the year ahead.

**EVANS:**

All right. So that to you says that even the all time highs we've seen for these stocks. And you've been bullish. I remember well our previous conversations where you've said they will continue to perform. And that sounds like today's data point just underscores that.

**AHLERSMEYER:**

Totally agree. I've answered this question now. I think three times on the program, What do we do with the stocks at the all time highs here? The stocks are at all time highs. The book values, though, are also at all time highs. So if you look at the valuations, yes, they're closer today than they were earlier in the year. But valuation on book is actually still pretty attractive relative to some of the stronger returns on inventory and returns on equity we've ever seen in the builders. We put out this outlook report two weeks ago. We've had a lot of discussions with people about how to conceptualize valuation at a time when cash flows are much, much stronger, and balance sheets are in much better shape than they've ever been. And so should we really be valuing these things on the historical cost of inventory? Or should we start to look at them more on the basis of future cash flows, like any investor does with any company? We think that that's the right way to think about it. And we're looking forward to having more of those conversations as builders decide to continue to drive good free cash flow by not necessarily reinvesting in land, but returning cash to shareholders through buybacks.

**EVANS:**

What's the biggest pushback you're getting on your bullishness?

**AHLERSMEYER:**

I think the biggest pushback is it's the typical I would almost call it a lazy thesis of look, this is how it's happened in the past. The stocks get expensive. People start talking about rerating, the builders do something stupid. They get undisciplined. They buy something. It really does actually depend on what the builders do from here and not necessarily how investors decide to think about it. The builders, it's actually totally the ball’s in their court. If they decide to say we’ll be more disciplined, not necessarily chase bad land deals just to continue to pursue growth, but actually shrink the business potentially on purpose to drive higher value per share and higher free cash flow per share, that would really force investors’ hands around valuation.

**EVANS:**

And that's interesting because our last home builders guest a couple of days back said he thought the land piece of this was really important. He mentioned that they're using for instance options. It's a little bit more of an asset like strategy, but it sounds like discipline in that area is one of the top concerns for investors. And in some ways, this whole discussion reminds me a lot of talking about the oil companies and the ways that they traditionally invest in and spend over their cycles.

**AHLERSMEYER:**

Absolutely. I really like that you drew that comparison. Looking at options, it's great because you can put down 10% of the whole value of a deal instead of having to put down 100%. That's certainly a more capital light way to do it, but it doesn't necessarily mean that you're doing better deals. You could put down 10% on a terrible deal for that matter, or you could do 20 times as many deals at 10% and be putting more capital down. What I really think is important about what you just said though is in the oil and gas industry, not that I'm an oil and gas expert here, but capacity was not the best incremental use of capital when it came time to looking at dividends and increasing leverage and doing dividends and buybacks. I think it's the same thing here. Home builders should really look at the constraints that they themselves were talking about on the labor and materials and land side and say, is it really the best use of capital to go and pursue what is likely to be higher and higher cost deals when our stocks are something that's relatively attractive in a few.

**EVANS:**

Yeah, or again, almost reminds me of the insurance industry where you can kind of give up pricing to chase or keep market share and how (Warren) Buffett was always like, no, don't. My quick final question/observation is when the Fed pivots, builders traditionally outperform. That's exactly what's happened over the past six weeks. They are up 41% in seven weeks. Do you worry if we kind of ignore all the great fundamentals you outlined, just talk about the technicals of it, that this move is simply operating off of the Fed pivot and nearly out of gas?

**AHLERSMEYER:**

Yeah, and this has been a crazy year. If you look at the charts just from a year to date perspective, they went up and then they went down and they went up again. So the 40% or so, I think I heard you quote on the lead in that's off of a trough that came off of a peak earlier in the year and rates kind of went up and they went down, so I don't know that I'm really looking at the relative strengths of the stocks or anything like that. But if you look at the price to tangible book value multiples, we will acknowledge that they are towards the upper bound of a typical valuation range for the stocks. And that would mean in next year, they do face a little bit of evaluation headwind. So I wouldn't expect the stocks to be up 100% next year. Because coming into this year, the price to tangible book values were indeed very, very inexpensive. We don't have that condition going into ‘24.

**EVANS:**

Joe, we appreciate your time. Good to check in with you. Thanks so much.

**AHLERSMEYER:**

Thanks a lot, Kelly.

**EVANS:**

Joe Ahlersmeyer from Deutsche Bank.