CalAtlantic Group, Inc.– CAA

Buy – Target: $45.00

Current Price: $36.50

Report Date: March 14, 2017
Analysis By:

Jimmy Copell
Jimmy.Copell@jwcresearch.com

Jing Zhou
Jing.Zhou@jwcresearch.com

Investment Thesis

In 2015 Ryland Group and Standard Pacific merged to form the CalAtlantic Group (CAA). Today, CAA is the 4th largest home builder (by revenue) in the United States. Herein lies the opportunity: CAA has remained undervalued relative to its now large cap peers. We believe this is due to the street simply not giving CAA the mindshare that companies like Toll Brothers (TOL) and PulteGroup (PHM) receive.

We believe that CAA is a top homebuilder trading at a discounted valuation. We expect investors to gradually realize this mispricing and drive the price higher to our $45 price target. Ever since the merger, CAA have expanded their coverage coast to coast as well as improved their competitive advantage over most smaller homebuilders in negotiations with contractors. We believe this will allow them to maintain a return on equity (ROE) of greater than 14% which calls for a higher multiple than is currently being assigned to CAA. We recommend a buy with a price target of $45.

Reason to Buy

Valuation: CAA is the ideal valuation play. Compared to other large homebuilders, a discount has been applied as if CAA is still a smaller player in the industry. Since the merger, CAA has improved their liquidity, geographic coverage and growth potential to be among the top homebuilders. It is in this light that we expect CAA's valuation to move in line with its peers. With this convergence to its peer group and the broader growth we expect from the homebuilders at both a top and bottom line, we expect CAA to outperform over the next 12-18 months.

Short Interest and Share Repurchases: Short interest stands at 15.3% of the float or 10.7 million shares which would take about 15 days to cover. Combine that with a $0.04 quarterly dividend – which now must be covered by the shorts – and a price that is moving nicely to the upside and we expect short covering to start once the stock gets above $40. This should allow enough of a catalyst to get it closer to our $45 price target.

Recommendation Details

Rating	Buy
Stock Price	$36.50
1 Year Price Target	$45.00
Potential Upside	23%

Market Data

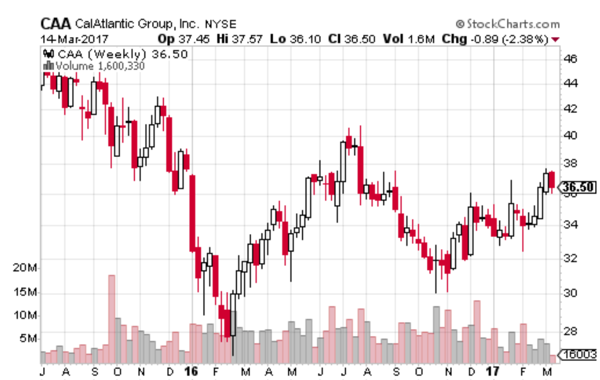
Market Cap (Mil)	4,188
Avg Volume (3 Mo) (000)	1,090
Yield (%)	0.44
Trailing 12 Mo Total Rtn	16.06%
Beta vs SPX	1.16
Short Interest (%)	15.34

Quarterly Earnings	Q1E	Q2E
JWC Research EPS	0.59	0.91
Concensus EPS	0.56	0.89

Annual Earnings	2017E	2018E
JWC Research EPS	3.89	4.28
Concensus EPS	3.74	4.19

Source: Bloomberg, JWC Research

Weekly Chart – CalAtlantic Group



Source: Stockcharts.com

Summary

***Please see disclaimer at the end of this report.**

2017 JWC Research. All rights reserved. No part of this report may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying or by any information storage and retrieval system, without permission in writing from JWC Research.

This Report is limited solely for the use of clients of JWC Research – DO NOT Forward

Company Description

CalAtlantic Group, Inc. builds single-family attached and detached homes in the United States. The company operates in four regions: North, Southeast, Southwest, and West. They offer crafted homes from entry level to luxury in 41 metropolitan areas spanning 17 states and the District of Columbia. CAA also provides mortgage financing and title examination for homebuyers. The company was formed on October 1, 2015 when Standard Pacific Corp and Ryland Group merged. CalAtlantic Group is headquartered in Irvine, California.

Industry Overview

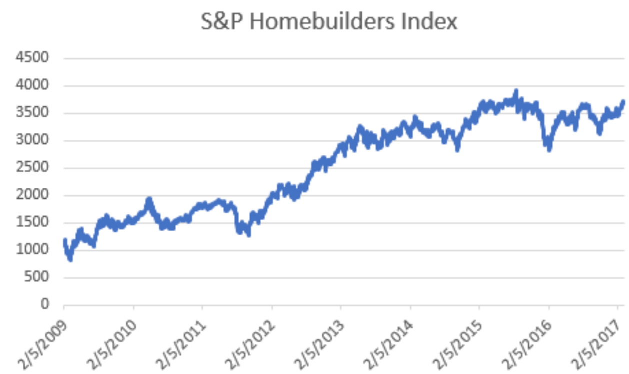
The homebuilding industry has seen a few good years since the recession of 08/09. Using the S&P Homebuilder Index as a benchmark, we see that the homebuilders have climbed an average of 19% a year since the homebuilder's bottom in February of 2009 (Figure 1). In August of 2015, the industry reached its peak and has struggled to move much higher. With the new administration and improving industry drivers, we expect this entire industry to continue its trend higher over the next few years.

Key Industry Drivers: For a strong housing market to exist, we need a few things: A strengthening demand for new homes (Figure 2), a reduction of homes for sale (Figure 3) and credit availability to those households that qualify for a mortgage (Figure 4). Each of these trends are positive with plenty of upside.

Rising Households: According to the U.S. Census bureau, there are now more millennials than there are baby boomers. Combine that with baby boomers that are living longer and staying in their homes longer, and we have built-in demand growth for new homes.

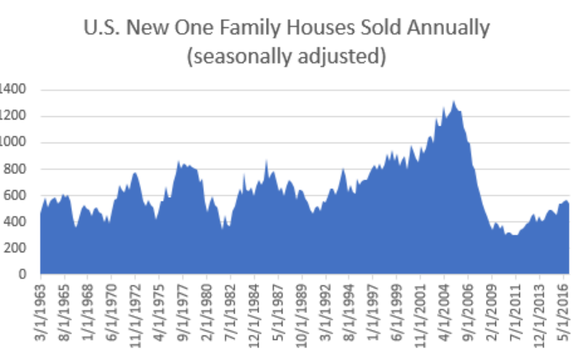
The Struggle: When examining housing starts (Figure 5), we recognize that there is a long way to go to get to historically normal levels. There is no doubt that this has created a concern among the typical homebuilder investor. It is through this lens that we have chosen to look more opportunistically at the homebuilder's industry. We believe the industry as whole will continue to grow, but true outperformance will come from wisely choosing which homebuilders offer the most value. Hence the reason we chose CalAtlantic Group.

Figure 1. S&P Homebuilders Index



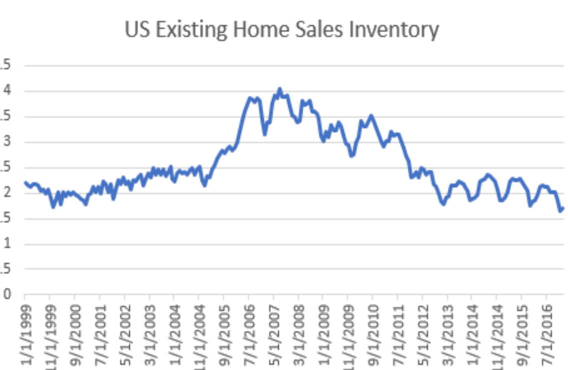
Source: Bloomberg

Figure 2. Houses Sold Annually



Source: National Association of Realtors

Figure 3. Inventory



Source: Bloomberg

A Closer Look

This Report is limited solely for the use of clients of JWC Research – DO NOT Forward

Wrap Up: Land acquisition is a huge cost for homebuilders. Coming out of the real estate collapse, many homebuilders were scooping up plots of land as fast as possible. This puts pressure on return on equity (ROE) as land tends to be a significant cost. It now appears that many of the large home builders are slowing the acquisition of land relative to the post collapse era, which should allow them to improve their ROE over the coming years. This improving ROE should lead to better valuations.

A Quick Look at Operations

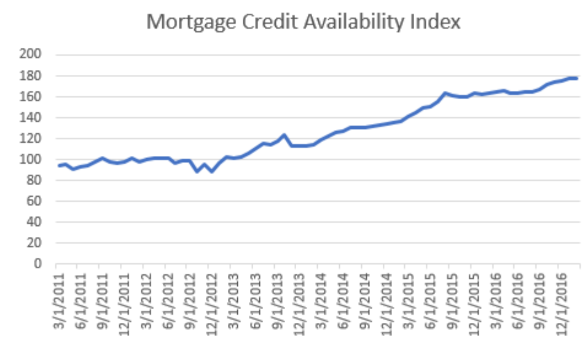
CAA is one of the most diversified homebuilders, building communities in more than 40 metropolitan markets in 17 states. These regions are broken into four groups: North, Southeast, Southwest and West. Figure 6 illustrates the percentage of deliveries by region.

Pre-merger Ryland focused on a high ROE strategy, while Standard Pacific focused on the higher margin California market. Combined, CalAtlantic focusses on luxury homes and the move-up markets (previous home owners looking to upgrade) across a wide geographic base. It has been their assertion that these markets offer the greatest value for their invested capital, and we agree with this strategy.

Margins: Typically, the higher priced homes offer better margins. Figure 7 demonstrates how far above the national average CAA is. This is the advantage of CAA's corporate strategy of predominantly sticking in the luxury and move-up markets. We do expect this average selling price to come down a bit in coming quarters as much of the average selling price in the West came from California communities which are on the tail end of closings as of the end of the 4th quarter. Since they tend to focus on the higher end markets, we expect them to be able to maintain pricing power with their customers and maintain respectable margins despite the pullback in California.

Seasonality: The crucial spring selling season for homebuilders begins in February and ends in June. Based on commentary from management (CAA's and other homebuilders), the 2017 spring season is expected to be a solid one. It is expected that CAA will have an increase in average selling price in most regions and new orders with limited cancellation this season. Given that it takes about five months to build a house, deliveries and cash flows are typically higher in the second half of the year. (continued on next page…)

Figure 4. Mortgage Credit Availability

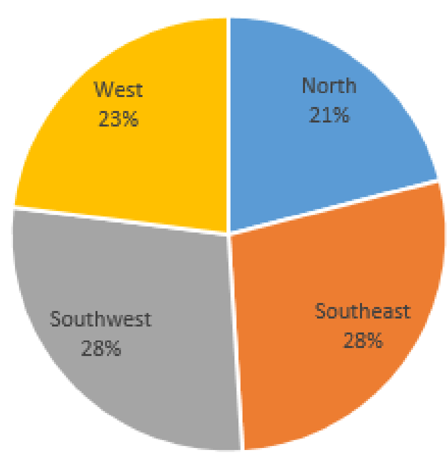


Source: Mortgage Bankers Association

Figure 5. Housing Starts

Source: Bloomberg

Figure 6. Homes Delivered



Source: Company Filings

This Report is limited solely for the use of clients of JWC Research – DO NOT Forward

Financial Services: In trying to be a "one stop shop" for the home buyer, CAA offers mortgage services. We mention it here to round out the description of management's strategy, even though fees generated from this segment accounted for less than 2% of revenues. Although it should be brought out that over 7,000 mortgages were completed in 2016 which does have a material impact on the top line from a "homes sold" perspective.

Backlog: CAA's backlog of orders for 2017 were $2.6 billion or 5,817 units with 2,757 expected to close in the first quarter. We find the backlog to be an interesting consideration, but it's nothing more than a starting point. Looking back at their history illustrates how much backlog varied from actual results. Management explained this discrepancy by pointing out that orders in the backlog are often not completed with their design yet. Therefore, it's possible that the buyer elects to make changes that will materially shift the value of the home. Although, three out of the past four quarters, reported results were higher than what the backlog indicated, both on a revenue and margin basis.

Wrap Up: We believe that CAA is well positioned for growth over the next 12 to 24 months. Although the cost of land sales, home construction and other inputs have been a major downside risk for homebuilders, we remain optimistic regarding expected gross margins. This is due to a good start in 2017 as incentives have moved down while net sales continuing to climb. In addition, as a leader in the move-up and luxury market segments (78% of home deliveries), CAA's revenue growth prospects are likely to overweigh the increased land prices and input costs. We expect CAA to continue to strategically acquire land and plan communities that are in line with increasing their average selling price while simultaneously improving margins, albeit modestly.

Figure 7. CAA Average Selling Price

Source: Company Filings, S&P Case-Shiller

This Report is limited solely for the use of clients of JWC Research – DO NOT Forward

Management

Our View: After the merger in 2015 the management team for CAA was selected from Ryland and Standard Pacific. Scott Stowell, the former CEO of Standard Pacific is now the Executive Chairman of CAA. Larry Nicholson, the former CEO of Ryland, is now the CEO. This trend continues right down the line with the top prospect for each executive position filled from the two companies.

Although the combined track record of this management team is short, we are pleased with their strategy and business performance so far. Corporate synergies have come in better than promised and we expect this to continue the longer this team is together.

JWC Valuation

Valuation: We believe the best valuation methodology is forward looking price to tangible book value for homebuilders. Utilizing 12-month forward book value for the five largest homebuilders (by revenue), Figure 10 illustrates how undervalued CAA is. Trading at 1.0x 2017's book value, we expect this disparity among the homebuilders to correct itself over the next 12-18 months as they revert to the average of 1.4x.

Using a 1.4x multiple for CAA is supported by our forward 12-month ROE of just over 14%. This 10x relationship (14% ROE / 1.4x=10x) is in line with the normalized historical relationship for homebuilders. Therefore, we have utilized a 1.4x multiple on 2017 projected tangible book value of $32.06 (Figure 9) to derive our $45 price target.

Capital Structure: As of the end of Q4 2016 CAA held $3.5 billion in land and land under development, $2 billion in completed and under construction homes and $0.5 billion in model homes. They had a $750 million line of credit with $637 million available and $200 million in cash. All of this is offset by about $4.5 billion in liabilities. The dominant use of cash is land acquisition and development as well as share repurchases. We expect land acquisition to remain at a consistent rate in 2017 and any additional cash flow to go towards share repurchases. Overall, we believe that CAA's capital structure is solid and worthy of the credit upgrade they received from Moody's shortly after the merger.

Figure 8. Estimates & Key Data

Debt Ratings		
S&P	BB	
Moodys	Ba2	
Multiples	**2017**	
Forward P/B	1.4x	
Forward P/E	11.0x	
Market Data		
Market Cap (M)	4,188	
Avg Volume (3 Mo) (000)	1,090	
Yield (%)	0.44	
12 Mo Total Return (%)	16.06	
Beta vs SPX	1.16	
Short Interest (%)	15.34	
Quarterly Earnings	**Q1E**	**Q2E**
JWC Research EPS	0.59	0.91
Concensus EPS	0.56	0.89
Annual Earnings	**2017E**	**2018E**
JWC Research EPS	3.89	4.28
Concensus EPS	3.74	4.19

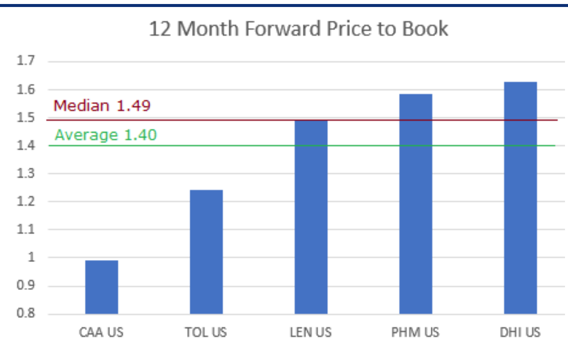
Source: Bloomberg, JWC Research

Figure 9. JWC Valuation Calculations

1 Year Price Target	
Tangible P/B Valuation	
Multiple	1.40x
2017E Tangible BV P/S	32.06
Target Price	**$45**

Source: JWC Research

Figure 10. Forward Price to Book



Source: Bloomberg

A Closer Look

This Report is limited solely for the use of clients of JWC Research – DO NOT Forward

Risks

Margin Expectations: The cost of land sales, labor and other inputs has been the major headwind for the homebuilding industry and this puts pressure on gross margins. Labor and material shortages could further reduce sales. However, with CAA concentrating on move-up and luxury markets, homebuyers will tend to spend more money on quality services and home sale revenues are expected to grow more significantly than the increase in selling expenses. If they move too far into the entry-level markets, we would expect volumes to increase but margins to decrease. We would expect this to have a material impact on our valuation.

Cyclical Demand: Demand for new homes is sensitive to changes in economic conditions and can change rapidly depending on market cycles, consumer confidence, availability of financing and interest rates. CAA may be adversely impacted by the rising mortgage rates as well as the market value fluctuations due to land holdings. The upcoming spring selling season is important, and year over year revenue growth in 2017 is expected to be solid. If this demand is below our expectations, this would have an adverse effect on our valuation.

Return on Equity: CalAtlantic has been trading consistently cheaper than its peers with a superior ROE to most homebuilders. If the broader housing market underperforms our expectations, then net income and ROE would decrease, and the 1.4x price to book multiple may no longer be appropriate.

This Report is limited solely for the use of clients of JWC Research – DO NOT Forward

JWC Rating Systems

Buy: The stock's total return is expected to outperform the S&P 500 over the next 12 months.
Sell: The stock's total return is expected to underperform the S&P 500 over the next 12 months.
Avoid: The stock's total return is expected to materially underperform the industry being analyzed over the next 12 months.

JWC Research Disclaimer

JWC Research is an independent investment research provider and is not a member of the FINRA or the SIPC. JWC Research is not a registered broker dealer and does not have investment banking operations. The JWC Research trademark, service mark and logo are the intellectual property of JWC Research Inc. The information contained in this research report is produced and copyrighted by JWC Research, and any unauthorized use, duplication, redistribution or disclosure is prohibited by law and can result in prosecution.

The content of this report may be derived from JWC Research reports, notes, or analyses. The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but JWC Research makes no representation as to their timeliness, accuracy or completeness or for their suitability for any particular purpose. This report is not an offer to sell or a solicitation of an offer to buy any security.

The information and material presented in this report are for general information only and do not specifically address individual investment objectives, financial situations or the particular needs of any specific person who may receive this report. Investing in any security or investment strategies discussed may not be suitable for you and it is recommended that you consult an independent investment advisor. Nothing in this report constitutes individual investment, legal or tax advice. JWC Research may issue or may have issued other reports that are inconsistent with or may reach different conclusions than those represented in this report, and all opinions are reflective of judgments made on the original date of publication. JWC Research is under no obligation to ensure that other reports are brought to the attention of any recipient of this report. JWC Research shall accept no liability for any loss arising from the use of this report, nor shall JWC Research treat all recipients of this report as customers simply by virtue of their receipt of this material.

Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance. JWC Research officers, employees, agents and/or affiliates may have positions in stocks discussed in this report. No JWC Research officers, employees, agents and/or affiliates may serve as officers or directors of covered companies, or may own more than one percent of a covered company's stock.

This Report is limited solely for the use of clients of JWC Research – DO NOT Forward