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BZH - Q2 2020 Beazer Homes USA Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, and welcome to the Beazer Homes earnings conference call for the quarter ended March 31, 2020. Today's call is being recorded, and a replay will be available on the company's website later today. In addition, PowerPoint slides intended to accompany this call are available in the Investor Relations section of the company's website at www.beazer.com.

At this point, I will turn the call over to David Goldberg, Vice President and Treasurer.

David I. Goldberg - *Beazer Homes USA, Inc. - VP of IR & Treasurer*

Thank you. Good afternoon, and welcome to the Beazer Homes conference call discussing our results for the second quarter of fiscal 2020.

You should be aware that during this call, we will be making forward-looking statements. Such statements involve known and unknown risks, uncertainties and other factors, which are described in our SEC filings, including our Form 10-Q, which may cause actual results to differ materially from our projections. Any forward-looking statement, including any statement expressing confidence regarding future outcomes, speaks only as of the date the statement is made, and except as required by law, we do not undertake any obligation to update or revise any forward-looking statement whether as a result of new information, future events or otherwise. New factors emerge from time to time, and it is simply not possible to predict all such factors.

Joining me today are Allan Merrill, our Chairman and Chief Executive Officer; and Bob Salomon, our Executive Vice President and Chief Financial Officer.

I will now turn the call over to Allan.

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Thanks, David, and thank you for joining us on our call this afternoon. Before we get started, we want to express our sympathy to those who have been personally impacted by the COVID-19 pandemic. We recognize that there has been a profound loss of life, and many Americans are still fighting the illness in health care facilities and at home. We also sincerely appreciate all the first responders and essential workers who are supporting the country during this challenging time.

As most of you have probably anticipated, this is going to be a very different earnings call. In light of the extraordinary environment and taking into account recent SEC guidance about earnings calls, we have substantially modified the format and content of this quarter's call.

First, we will give a very brief summary of the results we reported today. You'll find our traditional operational and financial slides included in the appendix to the presentation. Then, we'll describe our immediate and ongoing response to the crisis, both operationally and financially. This will include a discussion of April activity, though we obviously don't have final numbers for the month yet. Having reviewed our efforts to date, we'll discuss the primary risks we see moving forward and how we're approaching these risks.

After our prepared remarks, we will take questions in the time remaining. Given the uncertainty in the economy today, we're withdrawing any goals or guidance we offered in our earlier public comments. And we will not be giving any guidance for the next quarter or the full year.

So turning to our second quarter results. Despite the challenges that emerged in the final weeks of March, we had a successful second quarter, specifically new home orders increased 4% to 1,661 on spec -- sales per community per month at 3.3. Prior to the onset of the crisis, we were on page for the highest level of second quarter orders in the past 10 years. We grew our top line by 16% as we benefited from both increased home closings and a higher ASP.

Homebuilding gross margin, excluding amortized interest, impairments and abandonments, was up 100 basis points to 20.8%, reflecting both the strength of the market pre-crisis and the success of our product simplification initiatives. SG&A as a percentage of total revenue was down 70 basis points versus the prior year. Together, these results drove adjusted EBITDA at 35% year-over-year and led to $10.6 million of net income for the quarter.

In a normal environment, we would be enthused by these results since we achieved or exceeded all of our quarterly expectations, and we would be discussing the balance of the year with a lot of optimism. But of course, these are not normal times. In early March, it became clear to us that the COVID-19 pandemic was going to be disruptive to the economy and to our business. While we didn't know exactly how disruptive, we began a process of modifying both our business practices and our spending. I'll describe our operational response, then Bob will discuss the decisive steps we are taking to manage our liquidity.

Safety has long been our highest priority at Beazer. Our initial response was to help protect our employees, customers and trade partners by closely following CDC and state health authority guidelines. This has taken several different forms across our company. In our communities and our design studios, our employees are practicing social distancing and using enhanced cleaning procedures. Our sales teams have shifted to an appointment-only home sale process, and both they and our designers are leveraging virtual sales tools to connect with our customers.

On our job sites, we're requiring that our builders and trades wear appropriate protective equipment, and we've adjusted vendor schedules to allow for the necessary social distancing. We have also reached out to existing homeowners and neighbors, asking them to report to us any observations of unsafe job site practices.

For our customer care teams that we've had to suspend in-home visits, we're still committed to driving high levels of buyer satisfaction. To accomplish this, we're increasing communication and resolving issues remotely wherever possible. At our offices, we were early to adopt a mandatory work-from-home policy and have been pleased with the sturdiness of our IT infrastructure to provide remote access to our various software applications and tools. Finally, we adopted illness and testing tracking to allow us to react to any reported symptoms and COVID test results with detailed operational cleaning and quarantine rules for various scenarios.

Once we address the health aspects of the pandemic, our next highest operational priority was delivering homes to our buyers as close to on schedule as possible. The onset of the crisis caused significant logistical disruptions in finishing and closing homes, and we changed our processes accordingly. By working through these hurdles, we met our buyers' expectations for March, helping to bolster our liquidity.

While we focused on closing homes, we also took a hard look at all of our operational and administrative processes to see what else needed to change in this new environment. By the 1st of April, we were able to roll out comprehensive operating instructions for every department in the company organized around some key priorities, including protecting health and safety, generating cash flow and reducing cash expenditures. Tomorrow, we will update these operating instructions, adding plans for the gradual reopening of our offices and sales centers as conditions permit.

The strong sales we experienced in January and February carried over into early March. But by mid-month, our pace had weakened considerably, and our ability to anticipate demand essentially disappeared. With rapidly changing federal, state and local rules about which activities were allowable or essential, there was significant turmoil in each of our markets. This continued into early April.

Since the first week of April, however, we've seen sequential improvements in our gross sales activity each week. While gross sales remain below the prior year, the gap has narrowed. To be clear, we're not reading too much into this improvement yet. Even in normal times, we wouldn't recommend extrapolating a trend from a few weeks of data, which is why we don't typically report weekly sales results. In fact, we are still anticipating and preparing for home sales below normal seasonal levels for the foreseeable future.

Turning to cancellations. While they remain a very low percentage of our backlog, they are running above historical levels. In the first 3 weeks of April last year, we experienced 65 cancellations, which represented approximately 3% of the March backlog. In the same time period this year, we've recorded 82 cancellations or about 4% of the March backlog. And although we've seen a reduction in weekly cancellations since the peak at the end of March, we expect to experience a higher-than-normal cancellation rate until conditions in the broader economy stabilize.

Finally, as it relates to pricing and margins, we haven't yet seen a notable increase in price discounting in our markets. And consequently, margins have held up despite the slowdown in sales. Price cutting remains a threat, but across our footprint, low levels of finished new home inventory, a slowdown in new starts and consumer concerns about visiting resale properties may mitigate some of this risk.

As we have all had to adopt to a more virtual or online environment, it might be useful to take a step back and look at the top end of our sales funnel, which are the leads we receive from consumers from our various online marketing activities. Many of you may not recall that I joined Beazer after spending 7 years in the online real estate space, essentially creating leads for realtors, homebuilders and apartment communities. So this is a particular area of interest for me.

Last summer, we made changes to our online marketing efforts to improve the quality of the leads we were receiving rather than just emphasizing the quantity. This was done to ensure that every lead deserved and received an immediate and personal response from someone trained to assist in the home search process. These changes were expected to reduce lead volumes but increase quality without a material change to our online budgets. And that's exactly what happened.

Looking at online lead activity this calendar year, you can see that leads were down each month even as we were generating robust sales activity. But here is something that might prove to be important. In late March, our lead activity started to surge. And we have confirmed with the broader search sites that it wasn't just our leads, the entire category of online search activity for new homes has picked up materially. Of course, this has something to do with consumers spending more time at home and online during the crisis. And we realize no amount of search or lead activity can take the place of a job or a functional mortgage market. But even if our ability to convert these leads to sales is more difficult, we're pleased to have a larger group of consumers to work with.

With that, I'll turn the call over to Bob to highlight our financial response to the pandemic.

Robert L. Salomon - *Beazer Homes USA, Inc. - Executive VP, CFO & CAO*

Thanks, Allan, and good afternoon, everyone. As Allan discussed earlier, at the onset of the crisis, we took decisive actions to generate and preserve liquidity. We fully drew on our $250 million revolver in mid-March and put new processes in place to ensure that we could continue to close homes. We also deferred several land purchases. As we have previously reported, these actions led to total liquidity of $294 million, up over $70 million from the same time last year.

Looking forward, liquidity is a key financial objective because we do not want to be beholden to the capital markets in times like this. So let me describe the balance sheet and income statement aspects of our efforts to preserve and expand our liquidity in the quarters ahead.

On the balance sheet, our 2 largest categories of investment are WIP and land. At March 31, our WIP balance was approximately $100 million higher than in the prior year, driven by higher backlog and specs under construction. We expect this balance to decline, creating additional liquidity.

We also expect to generate liquidity by managing our land spending. Over 70% of our active land is owned, allowing us to generate significant cash flow from closings, particularly while we slow land spending. We are working with land sellers in each market to restructure, reduce or defer spending. And we have paused much of our land development spending, matching a slower sales pace and seeking improved terms from land development trades.

In terms of the income statement, we have also taken steps to improve liquidity. We are working with our construction trades to reduce our direct costs across the board and not just from reduced lumber costs. These efforts have shown immediate progress with most divisions targeting at least 3% savings in hard costs. We have also reduced operating expenses in most departments by, among other things, instituting a hiring freeze and delaying some significant but discretionary IT spending.

Finally, our senior leadership has taken a 20% reduction in salaries through at least the end of this fiscal year. We believe the actions we're taking put us in position to operate through the coming quarters without needing to access the capital markets even with substantially lower demand and higher cancellations than normal.

Now I'll turn it back over to Allan.

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Thanks, Bob. We've identified 3 primary near-term risks that our company and our industry are facing. First is reduced demand for new homes. While conditions will vary by market or higher unemployment persists, it will lead to lower housing demand and potentially put pressure on home prices.

Second is constrained mortgage availability. The mortgage market is facing a variety of challenges, including reduced liquidity among mortgage originators and a tightening of credit standards for borrowers. While we don't do a substantial amount of business at the lowest levels of creditworthiness, any contraction in mortgage credit or the elimination of certain loan types will hinder new home sales.

And third, there remains the potential for restrictions on our ability to operate, including the construction and closing of our homes. Currently, residential construction has been deemed an essential business across our markets, but this could change, especially if we see a reacceleration in diagnosed cases.

We don't know how these risks will play out, but we do know we won't be immune to their impacts. To help us manage through them, we're focusing on 2 key priorities. The first is to rely on our existing business model. Our longstanding operating philosophy has been to limit risk by focusing on existing markets, products and buyer segments and to compete for buyers by differentiating ourselves through the value we offer, not just the price.

In a volatile market, continuing the simple, value-driven approach should serve us well. In addition, we expect our Mortgage Choice program to be an even greater differentiator in this market. Connecting our buyers with a curated group of lenders who are competing with each other results in more access to credit and more choices for our buyers, which is certainly also good for us.

Our second priority is to protect our financial flexibility. We have worked hard over the last decade to dramatically improve our balance sheet. We've substantially reduced debt and lowered our annual cash interest expense by nearly $50 million. We have also termed out our maturities, eliminated maintenance covenants from our bonds and expanded our secured debt capacity. As we work through this challenging environment, we want to preserve flexibility to position us to return to our balanced growth approach when market conditions permit.

In closing, I want to thank our employees for their ongoing efforts through these challenging times. Under extraordinary circumstances, we have lived up to our cultural aspirations with attitudes that define focus, grit and accountability. I'm confident that we have the people, the strategy and the resources to weather the current storm and come out a stronger company.

With that, I'll turn the call over to the operator to take us into Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question comes from Alan Ratner.

Alan S. Ratner - *Zelman & Associates LLC - MD*

I hope everyone's doing well on your end, but glad to hear that you guys sound good there. So Allan, my first question, and maybe this is for Bob as well. I appreciate you walking through the levers on the liquidity that you're pulling right now to maximize cash flow. I think one interesting point that seems to be an area where maybe some builders are differing is that kind of thinking about the spec side of the business. And I know you're not a huge spec builder, but it seems like right now in this environment, just given how tight resale inventory is and given all the various uncertainty about what the market and the economy might look like 3, 6, 9 months from now, that spec inventory seems to be more desirable.

I know a lot of builders that have reported over the last couple of days that are more spec-heavy builders seem to be putting up slightly better April numbers than builders that are more to be built. And on one hand, you don't want to put more money into the ground that might be at risk in the future. But on the other hand, if that's where the stronger demand is today, certainly, that's an easier way to generate some sales and cash flow.

So just curious how that thinking has evolved over the last 5 or 6 weeks from you guys. How much is your start production down year-over-year? And have you maybe started to put the pedal down a bit in terms of starting new spec inventory?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Wow. Well, first of all, Alan, let me just say thank you for your comments and very much hope the same thing for you, your family, your company. So we ended March with nearly 900 specs, almost 250 finished specs, which was up, I want to say, about 80 year-over-year. So we've got a pretty good spec position. I wouldn't disagree with your characterization that specs have been quite attractive. And I think we were in a good spot relative to our spec position. We were pretty cautious the first 2 weeks of April on spec starts, no doubt about it. But we've worked, as we always do, with each division, each community. If they're selling specs, they're getting more specs. So we're not seized up and stopping. But we're not trying to pivot and dramatically change our model either.

The thing about having a mix of communities and buyer profiles is some communities in our company have been heavier specs, some are definitely more to be built. And we want to be in the market and competitive in each location. So we've tried to avoid swinging the gate all one way or all the other way kind of across all communities. We like our position, but I don't disagree with you, specs right now are quite attractive. And we are not restricting specs that we're selling in the communities where we're having success.

Alan S. Ratner - *Zelman & Associates LLC - MD*

Got it. That's helpful, Allan. I appreciate that. Second question, shifting gears a little bit to your comments on the mortgage side. I think this is an area where, depending on who you talk to, you get much different answers on exactly how impactful the tightening has been in the industry. And I know builders that have their own mortgage subs or joint venture programs, one of the things they are kind of touting is an ability to sell direct to Fannie, Freddie and Ginnie Mae. And therefore, some of the overlays that originators are instituting, they're able to kind of get around them a little bit by avoiding that part of the market, whereas you're dealing with, obviously, banks and nonbank lenders, I presume, in your Mortgage Choice program.

So can you just kind of walk through a little bit what the current standards that your mortgage partners are offering buyers? What has the tightening been, whether it's FICO, DTI? Any overlays that they're putting in place that you're dealing with today?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Well, you know our model has, I use the word curated, I guess. I don't need to use such a fussy word, but we have multiple lenders in each community that are competing for our customers' business. And that is very carefully controlled and designed, not just at the division level, but at the community level because we want to have lenders who want that business. And obviously, it makes it difficult then to talk broadly, that I will tell you that having competition has been a really good thing. There have been some lenders who have raised their FICO scores and other lenders who have not. There have been some who have had overlays, others who have been less concerned. And so one of the -- I think one of the great advantages of having a competitive environment is the people who want the business are in the business. And so we're not beholden to a particular lender, a particular program. And I think that's proven to be very, very effective here.

And you made a good point, we have both bank and nonbank lenders. And there are brands that are well-known. I'm not sure I really want to get into naming them. But I mean, it's -- big money center banks are part of our program. And so I feel like we've got ready access to the GSEs, FHA, Ginnie programs. I think our customers are finding that having eliminated the middleman in a builder captive, they've actually got lower rates than they would have if they were working with one of our competitors. And I think this environment is proving not just the pricing advantage, but also the access to capital advantage.

Alan S. Ratner - *Zelman & Associates LLC - MD*

So it doesn't sound like you think there's a big piece of the business that has evaporated in terms of your ability to get those loans done today?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

I do not. There are certainly challenges in the jumbo market. That's not a big part of our business. There is certainly more difficulty in the investor market. Again, not a big part of our business. So macro-wise, those have been categories that have been more hurt. But we have not seen, and I'm certainly aware of this from my industry perspective that some of the nonbank lenders in the servicing area, it's backed up into a liquidity problem on the origination side, we have not been affected by that.

Operator

Next question comes from Jay McCanless from Wedbush.

Jay McCanless - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

The first one I had, and I appreciate you guys putting the cancellation numbers out there. Could you just tell us what the April orders month-to-date are compared to April at the same time last year?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

I've got a nice graph here for you, Jay, but not the exact numbers in front of me. I would tell you, I think we started the month we were down more than 50%. And the most recent week, and today is the last week of the month, and I don't have this week's number, we were down well under 50%. So I think for the month as a whole, it will be under 50% by the time we get done this week, but it was certainly worse than that the first 7, 10 days of the month.

Jay McCanless - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

What about incentives, whether it's incentives to the buyers or paying some maybe higher co-broker fees, what is Beazer doing? And then what are you seeing from your competition right now?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

There's so little supply that we have seen very little in the way of change in aggregate incentives. We have changed a little bit packaging that -- but we're always doing that. And I wouldn't really say that that's as much COVID-related as it is just normal evolution. But we have not had a change in incentives of any magnitude in our company. And I'm not aware of our competitors' specific pricing strategies, but I haven't heard a lot of chatter about that either. I think as the prior question got to specs right now that are finished, ready to move in, they're pretty valuable. And I think we're finding not having a big need to change incentives.

Jay McCanless - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

And then on the community count, I know you guys are not giving guidance. But if I look at the schedule on Page 13 of the slides, I mean it looks like you're still going to be probably down just assuming natural attrition. I guess...

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

The thing about that chart, as you know, Jay, and you followed us for a long time, and I thank you for that, but the thing you know about that chart is the pluses and the minuses are kind of hidden in plain sight. They're right there. But it has never been harder for us to guess the timing. I mean the pace of closeouts, in a robust market, you tend to close out faster. In a softer environment, we may close out more slowly. To the extent land development is done, and we've got a community to open, we're not going to hold it back. So I think that there is more uncertainty as to the timing mix of closeouts and start-ups.

I'm pretty pleased with the fact that we've got nearly 45 communities either opening in the next 6 months or actively under develop, another 30 plus that are approved. I really couldn't tell you if I wanted to, what I think the exact pace of the closeouts is going to be. But there are at least as many in the -- with the plus sign in front of them as there are with the minus sign, but the timing is really tricky.

Jay McCanless - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Well, and that's where I was going with the question is not necessarily wanting the guidance, but if you guys are going to go a little bit heavier on specs, what you have is active communities right now. Do those lend themselves generally to flexing up the spec count and maybe closing out a little bit quicker? I don't want numbers, I just want...

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Yes. Look, there is not a -- we haven't made a command decision that, hey, if you've got 10 left, go put 10 specs in the ground. We try and make community-specific decisions. If it's a market and a community where specs have been a big part, we're certainly not restricting starting specs. But we've got some communities that are stalwarts that have been great, to-be-built communities throwing a bunch of specs in the ground for that buyer profile. It hasn't historically proven to be very effective. If it's not kind of a characteristic of competition in that submarket, I don't want to override the judgment of our division by telling them they've got to go start specs.

Jay McCanless - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Nice improvement in the backlog. What -- how much of that backlog is subject to a contingency where the buyer has to sell their current home or anything of that nature we need to be thinking about with the backlog?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Yes. We don't have a big move-up business, as you know. And so we have a very small percentage of that. I don't know the exact number, Jay. And certainly, contingencies are always in the backlog, but it is, for us, a very small percentage. I mean, clearly, the thing that we are more concerned about than that is loss of job. If you've got someone who's qualified, he's in backlog and then has an interruption in their employment, that's the thing that you and we are very focused on. And I'm really pleased with the way our team has engaged and connected with our buyers and talking to them about their situations.

And one of the things, it's kind of subtle, but one of the things I was actually pretty pleased with as we were pulling our materials together was to look at the cadence of cans kind of by week, and we're not going to be in the habit of doing things weekly. But one of the things you see is we deal with reality in real time. If we've got a situation where something in backlog needs to be canned, that's the week we take it. There isn't a kind of a "well, we'll wait until the end of the month or the quarter and see if maybe we get lucky" thing. So I think we've been dealing with reality in real time, and we'll continue to do that.

Operator

(Operator Instructions) Next question comes from Alex Barrón from Housing Research Center.

Alex Barrón - *Housing Research Center, LLC - Founder and Senior Research Analyst*

I wanted to ask if you've noticed any big difference in the performance of your entry-level product versus move-up versus gatherings?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

I know you don't -- I don't want to explain this in any kind of a tricky way, but it's a little bit hard to react to that question, and let me just explain why. Entry-level is sort of -- or is often kind of overlaid with first-time buyer. And when I think about our first-time buyer business, it's been very good. But our first-time buyer business does not tend to tilt to the lowest price points. We are affordable, and we're very competitive on the basis of value as opposed to exclusively on the basis of price. So I make that distinction because I couldn't, in a thoughtful way, comment on a more price-driven part of the market and the extent to which it has been or not been affected by the current circumstance. Our first-time buyer and first move-up buyer business has been pretty good.

I would say, on the gathering side, it's still relatively small for us, but there is definitely some effect from traffic, waiting until it's safer to come and visit the community. So I would say that's an area where we won't be surprised to have a little slower sales cycle. But I will tell you, in terms of leads and engagement, we feel great about that business. I just think we have to be a little bit patient about the stay-at-home orders being removed and older population being less at risk. And I think there are an awful lot of people that will be excited to be in a gatherings community. But as it relates to what you characterized as entry level, I would say our first-time and first move-up businesses are performing quite well, all things considered.

Alex Barrón - *Housing Research Center, LLC - Founder and Senior Research Analyst*

Okay. Great. And in terms of the build times, are you guys noticing any extensions because of social distancing or permitting or anything like that?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Yes. It's a little less on the permitting side, but it is definitely a function of not double stacking trades. We are maintaining really close control over these sites and not having multiple trades and multiple crews in a house. I can't give you at this moment a number of days delay, but I am totally certain that we will have a slower cycle time in production, certainly through April and May and probably extending beyond that somewhat. But we want to be safe, first and foremost.

Alex Barrón - *Housing Research Center, LLC - Founder and Senior Research Analyst*

Yes, of course. And then in the markets that are starting to reopen a little bit sooner, are you guys noticing more activity or interest or something like that picking up in other states that are maybe going to take longer to reopen?

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Yes, it's a really good question. We have moved across the company to an appointment-only sales environment. And we have been able to be compliant with all local requirements for the stay-at-home orders and essential workers and still had small appointments, 1 or 2 people touring a model in each of our markets. And that hasn't changed yet in any of our markets. We're still, for example, in Georgia, on a scheduled appointment. So I wouldn't tell you that I've seen a big difference between those markets that have made tentative early steps to open and those that haven't done it yet. But I can tell you that in every market, that online lead activity that I referred to is up pretty significantly.

Operator

We are showing no further questions at this time.

Allan P. Merrill - *Beazer Homes USA, Inc. - Chairman, President & CEO*

Okay. I want to thank everybody for joining the call today, and we will talk in next quarter. Thank you very much. This concludes today's call. Stay safe, and thank you for joining us.

Operator

That concludes today's conference. You may disconnect at this time, and thank you for joining.