MFIF

Minutemen Fixed Income Fund

FORESTAR GROUP (NYSE: FOR)

Analyst: Charles E. O'Rourke

We recommend an overweight position on Forestar Group's 2028 3.85% senior unsecured notes. Given FOR's growth profile over the next 2-3 years as well as its longer-term potential to be a leading participant in the consolidation of the land development industry, we view its valuation as inexpensive relative to our home builder universe's averages. Forestar represents a compelling investment opportunity due to its strong lot sales and revenue growth. These trends should continue as they expand their national footprint. Earnings growth should outpace top-line growth as the company decreases its Lot Banking activity, increases its sales of Forestar-sourced lots, and increases its sales to third-party homebuilders. Their relationship with D.R. Horton will provide them with built-in demand as they enter new markets and should help them expand their market leadership position. **We see a sustainable and growing strong demand environment in the homebuilding space, FOR's favorable position, and unrealized synergies within the Master Supply Agreement with DHI's to strengthen their top line growth, lowering cost structure facilitating margin expansion which will be realized by investors with the release of their 2022 10K. Because of this we see FOR's 2028 notes tightening ~75bps by 3Q23.**

Forestar Group							
LTM EBITDA, Leverage	207	3.4x					
Debt Outstanding (USD in Millions)							
Type	**Ammount O/S**	**Maturity**	**Coupon**	**Price**	**YTW**	**Market Value**	**Acc. Interest**
Senior Unsecured Note of 2026	400	5/15/2026	3.85%	$0.97	5.04%	388.0	0.10
Senior Unsecured Note of 2028	300	3/1/2028	5.00%	$0.95	5.38%	285.8	0.12
Total Debt	**700**					**674**	
(+) Market Capitalization	894					894	
(-) Cash	163					163	
(-) Prefered Stock	0					0	
(-) Noncontrolling Interests	0					0	
Enterprise Value	**1,431**					**1,568**	
Liquidity							
Revolver Commitments	0						
Revolver Outstanding	0						
Revolver Avaliability	0						
(+) Cash	163						
Total Liquidity	**163**						

Security Data

Bond Maturity: 03/01/2028
S&P Rating: B+
Rank: Sr. Unsecured
Price: $98.0
YTW: 5.38%
Next Call Date: 03/01/23
Coupon: 3.85%
OAS: 383.1 bps

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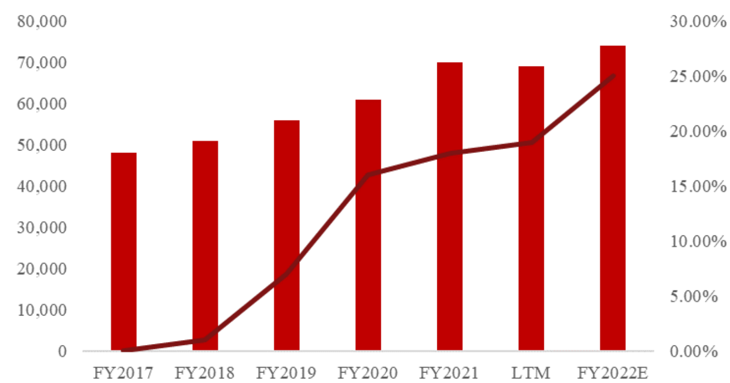
Company Description: Forestar Group Inc. (FOR) is a publicly traded land development subsidiary of D.R. Horton (DHI, Buy, $120 PT), which acquired a 75% stake in FOR in October 2017. FOR's strategy is to develop and sell to builders fully-entitled, low unit count new home communities with an emphasis on a quick return of capital. FOR calls its business "lot manufacturing". As of December 2021, FOR controlled 103,300 lots in 55 markets, primarily in the Sunbelt. FOR's Growth strategy is to take share from undercapitalized private developers and"region-to-national" market expansion.Forestar is the market leader in the highly fractionalized lot development industry. Fast top-line growth, coupled with greater operating efficiencies and improving sales mix, should allow Forestar's earnings to be quite robust moving forward. Forestar is a partially owned subsidiary of D.R. Horton, the nation's largest homebuilder, and the two companies have a Master Supply Agreement that mutually benefits them.

Strong revenue growth combined with greater operating efficiencies will drive margin expansion that will lead to robust earnings growth. Forestar's top line grew 42.28% in 2021 to $1.325 billion. This year we project revenue to expand by 28.22% to $1.7 billion. This growth will be mainly fueled by the company's expanding operating capacity in the markets where they currently do business. Forestar operates in 56 markets in 23 states where they own or control 103,300 lots. Their lot position has grown by 33.3% year-over-year, and this increase will allow them to expand the number of lots that they develop and ultimately sell. We forsee Forestar to grow its lot deliveries 23-26% in fiscal 2022, delivering 19,000-19,500 residential lots, generating ~$1.7B in revenue (+24% yoy) and we see pre-tax profit margin between 13.5% and 14% (+60 bps yoy) with the improvement driven primarily by gross margin expansion. We see revenue and pre-tax margin to be stronger in 2H22 than in 1H22. The pre-tax margin guide implies an SG&A/Sales ratio of ~5%, flat relative to 2021. FOR invested $1.6B in land spend in FY21 and expects to spend $1.75B in 2022 with half allocated to land acquisition and the other half land development. Another way the company is increasing margin is by sourcing more of their own projects. The reason sourcing their own projects positively impacts margin, is because when a homebuilder like D.R. Horton brings them a project, margin is impacted because D.R. Horton has leverage over the project's price. This is because they have the option to pass the opportunity along to another developer or to self-develop the project. In Q1 2022, 22% of total lots sold were from Forestar-sourced projects. That is up from 13% in the same quarter a year ago. The company has plenty of room to expand this number, as evidenced by their current lot position. Of the 103,300 lots that Forestar currently owns or controls, 54% of them are from Forestar-sourced projects. This should eventually lead to a higher percentage of sales coming from Forestar-sourced lots, which will help boost margins.

Figure 1: Geographic Footprint

Source: Investor Presentations

Figure 2: Relationship with DHI



Sources: Company Filings, MFIF Analysis

Figure 3: Lot Deliveies x Revneue Growth

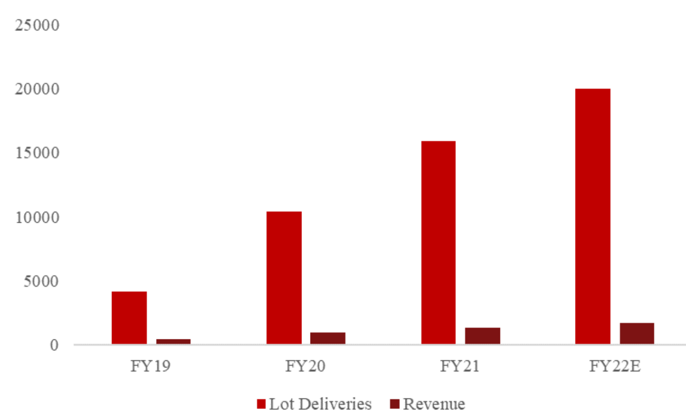
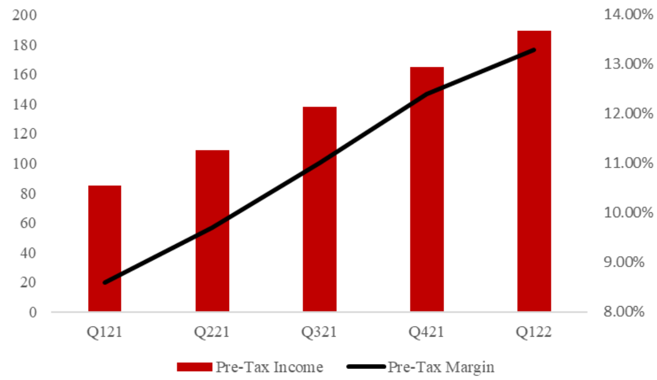
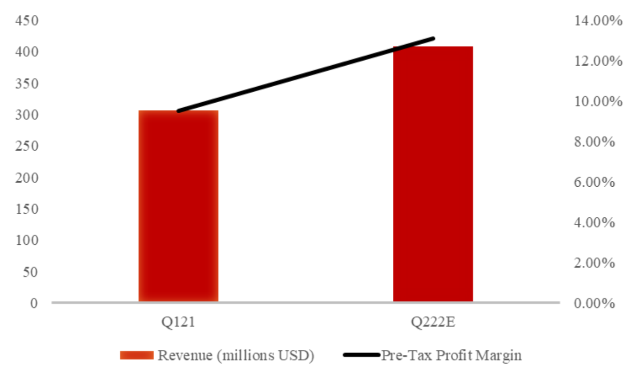


Figure 4: Margin Expansion



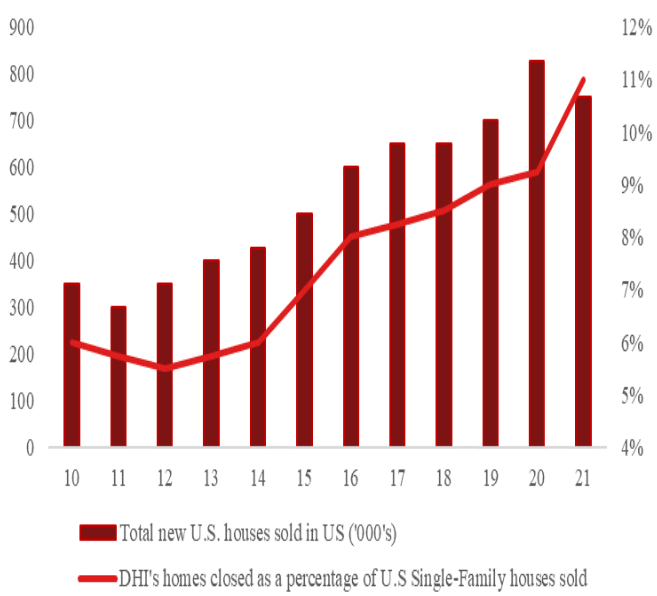
Source:Bloomberg Terminal

Figure 4 (expansion): Profit Margin w/ Revenue



Source: Investor Presentation, MFIF Analysis

Figure 5: DHI Roadmap for FOR as lot supplier



Sources: Company Filings, MFIF Analysis

Forestar is poised to gain market share in the highly fractionalized Lot Development industry and stands to continue to increase market share due to their relationship with the nation's largest homebuilder, D.R. Horton (DHI) Forestar's competition in the Lot Development Industry is mainly composed of small regional or local firms. FOR's current national market share is 2.2%, up from 1.4% in Q121 based on Forestar's trailing 12-month lot deliveries and new single-family homes sold in FY21. We see FOR is to achieve 5% national markets representing 1/20 new homes sold in the US being built on a Forestar developed lot. As one of the only U.S. Lot Developers with a national footprint, Forestar will be able to increase market shareto 5-7% by leveraging their scale and access to debt and equity capital. The company is further aided by their relationship with the nation's largest homebuilder, D.R. Horton. D.R. Horton bought a 75% ownership stake in Forestar in 2017 for $560 million. After the merger, the two companies entered a Master Supply Agreement. Under the terms of the Master Supply Agreement, both DHI and FOR actively look for lot development opportunities that will increase FOR's capacity. DHI retains the right of first refusal on any lots from projects that they source, and the right of first refusal on 50% of lots in projects sourced by Forestar. This is a mutually beneficial agreement for the two companies. Forestar receives the ability to expand rapidly, as they gain the nation's largest homebuilder as a consistent customer. 89% of Forestar's first quarter lot deliveries were sold to D.R. Horton. Since FOR's 1Q22 earnings report, DHI has entered a contract to purchase 20,000 lots from Forestar at a value of $1.49 billion. Forestar also gains the expertise of DHI's proven management team.FOR has consistently expanded its market share within DHI and we see FOR to supply ~33% of DHI's annual lot demand.

Market underestimation of Forestar's favorable position created by current supply constraints in the U.S. Housing Market as D.R. Horton and other homebuilders will eagerly look to purchase more lots in order to satisfy demand. DHI 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. D.R. Horton is positioned to grow sales as it expects to close ~91,000 homes in fiscal 2022, an 11% increase over fiscal 2021. We see FOR to experience continued strength in demand, being able to deliver lots more quickly than anticipated, and the supply chain stabilizing (versus expectations for further deterioration). As a result, FY22 revenue is now expected at roughly $1.7billion (up 28% YOY) vs. $1.65 billion (up 24% YOY). Throughout, FY22A we see FOR benefitting from several factors, including more lots sold from FOR own development (vs. land banking), at 97% of lots vs. 87% in 2Q21, more lots sold from FOR-sourced projects 22% vs. 13% in 2Q21) and FOR's strategy of pricing lots closer to the time of delivery, enabling the company to take advantage of the current strong demand environment. Analysts are expecting a 25% increase in home-sales revenue in FY22As while interest rate concerns may continue to represent a near-term overhang, we expect current demand to remain relatively healthy through at least 2022, absent another 50-75 bps rise in interest rates, which in turn should produce strong earnings growth; across building products, we largely favor catalyst-driven ideas. We expect the housing cycle to continue to progress over at least the next two years, which should support solid growth and margin expansion.

Comps (USD in Millions)	FOR	TPH	KBH	MTH
Market Cap	894	2,593	3,476	3,498
Debt	700	1,400	1,685	1,160
Cash	163	587	291	618
Net Debt	538	813	1,394	542
Enterprise Value	1,432	3,405	4,870	4,040
Revenue (LTM)	1,426	3,823	5,725	5,147
EBITDA (LTM)	207	491	578	768
Debt/EBITDA (LTM)	3.38	2.85	2.92	1.51
Net Debt/EBITDA (LTM)	2.60x	1.66x	2.41x	0.71x
EBITDA Margin (LTM)	6.92	6.93	8.43	5.26
FCF (LTM)	44	428	(77)	(200)
Individual Security Comps				
Rating	B+	BB-	BB-	BB+
Coupon	5.00%	5.70%	4.80%	3.88%
Maturity	3/1/2028	6/15/2028	11/15/2029	4/15/2029
Price	98.0	103.5	101.6	97.7
YTW	5.38%	4.99%	4.54%	4.24%
Z-Spread	411.9 bps	372.6 bps	307.1 bps	242.4 bps
OAS	383.1 bps	358.6 bps	296.1 bps	241.2 bps
Next Call Date	3/1/2023	12/15/2027	11/15/2022	10/15/2028
OAS/Turn of Leverage	147.5 bps	216.6 bps	122.7 bps	342.0 bps

Figure 7: Z-Spread, FOR & Peers, 3M+ Historcal Data

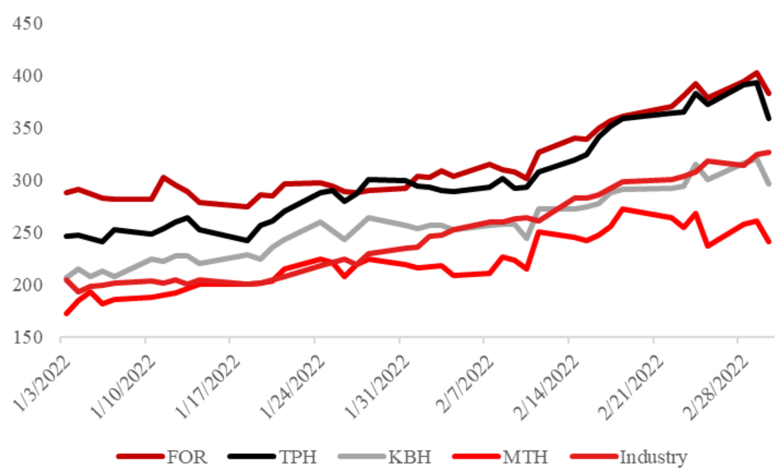
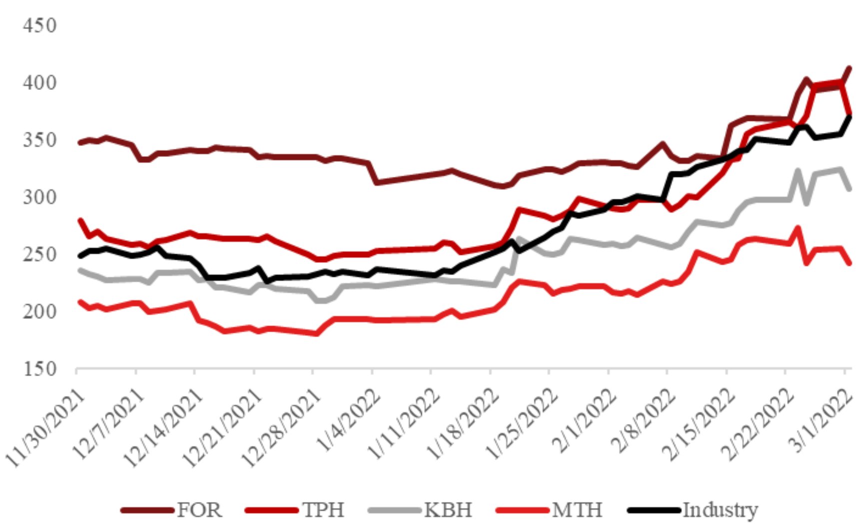


Figure 8: OAS, FOR & Peers, 2M+ Historcal Data



Source:Bloomberg Terminal

Risks to Thesis

- High product concentration towards the affordable first-time buyer segment could cause upside/downside to results based on demand from this buyer segment decelerating
- If FOR is unable to capture market share, lot deliveries may slow and hurt returns
- FOR's heavy reliance on DHI's financial performance may prove to hurt returns

Relative Value

FOR's 2028 Senior Unsecured Notes are currently trading at an OAS of ~ 411 bps. The notes had been tracking the industry's tightening trend since 3Q20, but saw a more dramatic widening relative to peers as tinvestors expressed more skepticism over the lag in homebuilding starts. Since this report came out on 9/07/21, FOR has widened ~50 bps. However, we believe this to be a market overreaction and an underestimation of FOR's growth profile relative to their competitors. FOR's relationship with D.R. Horton will provide them to be a leading participant of the consolidation of the land development industry. The current supply constraints favor FOR as homebuilders to purchase more lots which has yet to be reflected in their spread. Forestar has a visible path to capture 5% market share within a highly-fragmented U.S. single family residential lot industry.

FOR's notes are currently trading ~35 bps wide to those of TPH. While TPH does have a more favorable leverage ratio, Forestar group enjoys a much larger lot position and we see FOR's long-term potential to be much stronger than TPH Moreover, the company's leverage ratio is on track to improve much quicker than that of TMHC or FOR, we see FOR continuing to improve their Net debt/Ebitda ratio. With no debt maturing until 1Q26 FOR will be able to hoard their cash. For these reasons, we maintain our position to hold FOR 2027s until 3Q23 and sell them. We expect FOR's 2028 Sr. Unsecured Notes to tighten towards those of TPH by ~75 bps over the next 18 months as the market witnesses their rapid sales pace throughout FY22 and into FY23. <u>If our projections are correct we would enjoy a 11.65% total return built from a 5.68% total annualized return,</u>

Forestar Group (FOR)

Fiscal Year	FY20A	FY21A	3Q21A	4Q21A	1Q22A	2Q22E	3Q22E	FY22E
EOP Date	11/19/2020	1/27/2021	7/23/2021	11/18/2021	1/28/2022	4/23/2022	7/23/2022	11/18/2022
Income Statement								
Net Sales								
Development projects	616	1,183	275	386	393	413	433	1,698
Lot Banking	262	116	37	15	9	9	9	37
Other	54	27	2	18	6	11	11	11
Total Net Sales	932	1,326	313	419	408	433	454	1,746
Cost of Sales								
COGS	814	1,097	257	343	334	338	354	1,294
SG&A	46	68	17	20	22	22	23	71
Operating Profit (EBIT)	32	147	21	59	54	89	96	253
Interest Expense	43	42	10	10	8.20	10	10	10
Income Tax	16	36	5	15	13	14	19	61
Net Income	62	110	16	44	41	45	60	192
Revenue Growth								
Development projects	131.3%	40.8%	9%	40%	2%	5.0%	5.0%	18.0%
Lot Banking	1.4%	-55.6%	25%	-60%	-38%	1.0%	1.0%	4.0%
Total Revenue Growth	118.6%	42.3%	9.0%	33.8%	-2.6%	13.8%	6.0%	33.8%
Operating Metrics								
Operating Margin	8.4%	6.7%	5.8%	2.7%	-1.4%	13.8%	13.0%	15.0%
Tax Rate	23.7%	21.2%	24.6%	24.9%	24.3%	24.0%	24.0%	24.0%
EBITDA Reconciliation								
(+) EBIT	32	147	21	59	54	89	96	253
(+) Depreciation and Amortization	(5)	2	(2)	1	2	2	2	0
(+) Stock-Based Compensation	-	-	-	-	-	-	-	0
EBITDA	27	149	19	59	56	91	98	253
FCFF Reconciliation								
(+) EBIT*(1-Tax)	24	115	16	44	41	68	73	192
(+) Depreciation & Amortization	(5)	2	(2)	1	2	2	2	7
(-) Capex	0.2	(1)	(1)	(2)	1	1	0	(1)
FCFF	20	117	13	43	44	71	75	198
Credit Metrics								
Debt	641	704	705	705	700	700	700	700
Debt/EBITDA	24	5	36	12	13	8	7	3
Debt/FCF	35	6	52	16	16	10	9	4