LENNAR CORP

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11:00 am EST

Coordinator: Welcome to Lennar's Fourth Quarter Earnings Conference Call.

At this time, all participants are in listen-only mode. After the presentation, we will conduct a question-and-answer session.

Today's conference is being recorded. If you have any objections, you may disconnect at this time.

I would now turn the call over to Alex Lumpkin for the reading of the forward-looking statement.

Alexandra Lumpkin: Thank you, and good morning.

Today's conference call may include forward-looking statements, including statements regarding Lennar's business, financial condition, results of operations, cash flows, strategies and prospects. Forward-looking statements represent only Lennar's estimates on the date of this conference call and are not intended to give any assurance as to the actual future results. Because forward-looking statements relate to matters that have not yet occurred, these statements are inherently subject to risks and uncertainties. Many factors could affect future results and may cause Lennar's actual activities or results to differ materially from the activities and results anticipated in forward-looking statements. These factors include those described in this morning's press release and our SEC filings, including those under the caption "Risk Factors" contained in Lennar's Annual Report on Form 10-K, most recently filed with the SEC.

Please note that Lennar assumes no obligation to update any forward-looking statements.

Coordinator: I would like to introduce your host, Mr. Stuart Miller, CEO.

Sir, you may begin.

Stuart Miller: Very good. And thank you, Alex.

This morning, I'm here with Rick Beckwitt, our President; Jon Jaffe, our Chief Operating Officer; Bruce Gross, our Chief Financial Officer; Diane Bessette, Vice President and Treasurer; David Collins, our Controller; and, of course, Alex Lumpkin, from our legal staff who you just heard from. We also have Jeff Krasnoff, CEO of Rialto here.

As always, I'm going to start with a brief overview, and then Bruce will give further detail. We'd like to ask, as always, during our Q&A portion that you'd limit your question to one question and one follow up so we can accommodate as many as possible.

Today, I'm also going to ask Rick and Jon to give a brief update on our integration of the CalAtlantic strategic combination.

So let me go ahead and begin by addressing the elephant in the room by highlighting our fourth quarter bottom line miss that derived from the shifting of a one-time noncore, non-Rialto transaction. While this transaction is still covered by confidentiality agreement that restricts our ability to disclose its actual substance, we can say that it will produce more than the fourth quarter shortfall in the first quarter, and that profitability will benefit from the lower federal tax rate. Bottom line, this shift benefits the company overall.

Aside from the shifted transaction, we are very pleased to announce a very productive fourth quarter. We produced very healthy operating earnings, continued to track ahead of the target on our closed and fully integrated WCI transaction, announced our strategic combination with CalAtlantic, we began the pre-closing integration process for that industry-transforming transaction, we continued to grow our LMC Multifamily business, and we continued to position Rialto for a future on its own.

Generally speaking, let me say it's a very exciting time to be in the homebuilding industry, and it's particularly exciting to be working here at Lennar. At Lennar, we're focused on every aspect of our business as we continue to migrate the company to a pure-play homebuilding platform. And we continue to innovate and evolve our core operations to perform at the highest levels in the industry.

Through the end of the fourth quarter, we were able to continue to execute on our business plan and strategy of growing and refining our business while focusing on our balance sheet. We ended the year with a net debt to total cap of 34.4%, even after paying all cash for our WCI acquisition at the beginning of the year.

At the same time, the housing market has been strong, and it's getting stronger. There continues to be a general sense of optimism in the market as jobs have been created across the country and wages have generally been moving higher. The low unemployment rate and the labor shortage has been translating into wage growth. And the attitude of our customers continues to confirm the same sense that we have as business operators. And that is that the economic environment is generally strong and stable and improving.

Accordingly, we've seen new orders, home deliveries and margins continue to be at least in line with or above our expectations. Against that backdrop, the recently passed federal tax act has added additional momentum to the economic landscape. While many have been concerned about the effects of the new tax law on housing with its mixed bag of impacts, initial readings and reviews are suggesting that it is generally stimulative to the economy, and that is good for housing.

Concerns about the reduction of mortgage - of the mortgage interest deduction, deductibility of real estate taxes and state and local taxes seem to be offset by overall optimistic momentum around economic stability and growth. We have carefully studied the specific impacts of the tax law on our typical buyer profile in each of our markets. And we found that the effect is generally positive at their income levels. Additionally, the doubling of the standard deduction should help a new group of frustrated apartment dwellers accumulate savings for a down payment to purchase a home and create personal stability.

We continue to feel that the strong economy, together with limited supply and production deficits from past years, have been and will continue to drive demand and pricing power as we move through the upcoming selling season, even though that will be somewhat offset by land and construction cost increases. This really sets the stage for a very successful strategic combination of two of the largest homebuilders in the industry.

As you've heard from us before, we are very enthusiastic about our combination with CalAtlantic. This transaction is all about creating leadership and scale in the markets that we know best and with the product lines that have defined our companies for decades. With scale, we believe we can drive both synergies and efficiencies as we build best-of-class operating platforms in the most strategic markets in the country. We believe we can use technologies to innovate and improve our operations to drive cost down. And we believe that we have the best and most experienced operating team in the industry to integrate these two companies quickly, efficiently and seamlessly to drive these efficiencies quickly.

Already, you are seeing that the two companies have not skipped a beat since the announcement of the transaction. CalAtlantic announced sales, closings and backlogs for the fourth quarter this morning and exceeded expectations across the board. Likewise, Lennar's sales were up 12% over last year's, deliveries up 5% and backlog up 17%, all above guidance. Both teams of professionals have continued to execute and remain focused on the business at hand while preparing for the closing - the upcoming closing, on February 12.

In a break from convention on these conference calls, I'd like to spend some extended time on the CalAtlantic combination. Given the importance and significance of this combination and its integration, I have invited Rick Beckwitt and Jon Jaffe to provide transparency and give you an update on the progress of the integration planning and timing. I think you will see that we are focused on the details needed to move quickly and efficiently as we execute both on current and expected business accomplishments, as well as the complex task of bringing two great companies and traditions together without missing a beat.

Rick, could you start off?

Richard Beckwitt: Thanks, Stuart.

Let me start by reminding everyone that on October 30th, we announced our strategic combination with CalAtlantic for $9.3 billion, which included $3.6 billion of net debt assumed. The consideration included 80% stock and 20% cash. After we announced the transaction, we issued $1.2 billion of senior notes to pay for the cash portion of the acquisition. As Stuart mentioned, we anticipate closing the merger on February 12, 2018.

Our strategic combination with CalAtlantic will create the nation’s largest builder with latest robust revenues in excess of $19 billion. The combined company will have a Top 3 position in 24 of the 30 largest markets in the nation with the local market shares ranging from 20% to 40% in many markets. This local critical mass will drive huge savings.

During our due diligence period and since the announcement of the deal, we have been focused on integrating the two companies with a plan to drive both top line and bottom line performance. We have a detailed roadmap to recognize significant synergies through direct cost savings, reduced overhead cost, the elimination of duplicate public company cost, production efficiencies and technology improvement.

I’m happy to say that the CalAtlantic integration is right on schedule. Decisions have been made on regional presidents, division presidents and all corporate and division personnel. In selecting all personnel, we had a deep bench of high-quality associates from both companies to choose from. And we selected the best player on the field regardless of which company they work for. We’ve already spoken with all of the senior associates with regard to employment decisions. And we will communicate with the remaining associates in the next two weeks.

When the deal closes, we will have five operating regions, up from our current four, and 38 homebuilding divisions, up from our current 33. The new divisions include two new markets, Indianapolis and Salt Lake City, and three new divisions to accommodate the largest scale and footprint of our operations. These new divisions include San Diego, the LA/Ventura market and Orlando. The operations in the remaining 33 markets from both companies will be combined into one division per market, which will result in significant synergies and operating leverage. However, from a personnel standpoint across our entire footprint, we've retained key purchasing and land acquisition associates from both companies since these associates will drive significant cost savings and drive our go-forward growth in the company.

We've created an integration process and an execution team that includes leaders from both companies that touch all the relevant parts of our business. Our integration priorities have been technology decisions, land acquisition, product streamlining, EI conversion, value engineering and purchasing. We are well ahead of our timeline in each of these critical areas.

From a technology standpoint, the go-forward operating system decisions have been selected. System conversions are already being mapped out prior to the closing and will start the day of closing. Our goal is to be operating on one system simultaneous with the build-out of our CalAtlantic back log.

From the land acquisition standpoint, Jon and I and our regional presidents have been reviewing all significant land acquisition opportunities sourced by the CalAtlantic divisions since the announcement of the merger. This has allowed us to have a consistent underwriting, leverage our product profile of both companies, capitalize on cross-marketing opportunities and benefit from our increased local market scale when negotiating the purchase of these land assets.

From a product standpoint, as we did in the WCI integration, we have been culling through the home plans from both companies to identify the most efficient and best-selling plans. We have analyzed each community to determine whether we would make higher returns and profits by building CalAtlantic or Lennar products. In most cases, as expected, our Everything's Included Lennar product is both faster and cheaper to build. In some cases, the CalAtlantic Design Center product offering commands a higher sales price with outsized margins.

Yesterday, Jon and I completed our review of the development, construction and marketing schedule of all of the CalAtlantic communities. Of the existing 566 CalAtlantic communities, approximately 41% will remain CalAtlantic, 50% will be rebranded to Lennar over the next several quarters, with the remaining 9% rebranded to Village Builder or WCI, which are our Design Center brands. All future communities will be sold under the Lennar, WCI or Village Builder brands.

To facilitate this product conversion and rebranding process, Lennar and CalAtlantic entered into a master construction agreement that allows each company, prior to the closing of the merger, to construct homes designed by the other company on land owned by the other company. Pursuant to this construction agreement, we've already begun to pull permits and start homes in approximately 45 communities across the country. This type of forward thinking has given us a jump-start on product conversion and will accelerate the opportunity for us to benefit from faster cycle times and lower build costs. Purchasing and value engineering is by far the most important driver of this strategic combination.

I'd like to turn it over to Jon now to walk through this important element of the deal.

Jonathan Jaffe: Thanks, Rick.

We publicly announced that we expect to realize at least $75 million and $250 million in synergies in fiscal years 2018 and 2019, respectively. As reported in our S-4 filing, we told our board of directors prior to signing the merger agreement that we believe the synergies will be $100 million and $365 million in fiscal years 2018 and 2019, respectively. The majority of these synergies, $265 million in 2019, will come from lower direct construction costs. Given that the combined volume represents approximately 125 million square feet of homes per year, this equates to $2.12 per square foot, just a 3.7% savings from Lennar's current direct construction costs. Contributing to this 3.7% savings per foot will be the cost savings associated with Lennar's standalone volume as we would expect greater leverage as we increase our production from 75 million to 125 million square feet.

We've already put in place a world-class supply chain team made up of associates from Lennar, CalAtlantic and some new additions to the team. We are organized with a 15-member supply chain team, five regional purchasing vice presidents, three regional operating centers and our division purchasing teams. We will benefit from Lennar associates' experience in supply chain and Everything's Included execution and CalAtlantic associates who manages - manage the supply chain integration of the Standard Pacific-Ryland merger, as well as the Centex-Pulte merger. Lennar's three existing operating centers in Florida, Texas and California will be leveraged to efficiently process the purchasing activity of the larger organization.

We have a detailed roadmap by task and completion date to capture supply chain synergies which prioritizes action items. We've already evaluated the national contracts between the two companies and created synergy targets by category. Meetings have commenced with strategic manufacturers and suppliers, and we have already started awarding national contracts based on the combined volume. This week, we are at the International Builders Show taking place in Orlando in one-on-one meetings with all of the major vendors. Plans are in place for the exploration of private label manufacturing, vertical integration of components such as concrete block, trusses and panelization, along with product value engineering.

Plans for SG&A synergies are in place with our operational structure set, as Rick described earlier. Additionally, when CalAtlantic communities are converted to Lennar's efficient Everything's Included platform, we'll gain more leverage as we will see an average cycle time reduction of 20 days, as much as 50 days on the high side. This will increase the sales pace from two sales per month in those converted communities to a pace of three and a half to four sales per month.

The synergies of this combination will lower direct construction cost, reduce cycle times, leverage SG&A and increase sales pace, all of which will deliver greater profitability and internal rate of return on invested capital. Based on where we are in the integration process and the plans that are in place for execution, we're confident in our ability to deliver the cost synergies discussed in our S-4 filing for 2018 and 2019.

I'd now like to turn it back over to Stuart for some comments on this.

Stuart Miller: Great. Thanks, Jon. Thanks, Rick.

So as you can hear from Rick and Jon, simply put, we are on it. We have broken down the critical elements of this integration and we are executing exactly as you would expect from this team. As I've noted before, and we will demonstrate, continue to demonstrate as we go forward, we expect to bring these two companies together efficiently and effectively to build the best homebuilding platform in the industry and to drive savings and engage innovation in the process.

So with that, to give greater detail on our financials, let me turn over to Bruce and to David.

Bruce Gross: Thanks, Stuart, and good morning.

Our net earnings for the fourth quarter were $309.6 million or $1.29 per diluted share. The company's core operational metrics exceeded expectations. Excluding the strategic one-time transaction that Stuart highlighted shifted into the first quarter of 2018, we would have exceeded the consensus estimate of $1.47 by 4 cents. This compared to fourth quarter 2016 net earnings of $313.5 million or $1.31 per diluted share, which was favorably impacted by energy credits.

Revenues from home sales increased 14% in the fourth quarter, driven by a 5% increase in wholly owned deliveries and an 8% increase in average selling price to $387,000. At the beginning of the fourth quarter, we were impacted by Hurricane Harvey and Hurricane Irma, and we reduced our fourth quarter projections by 950 deliveries. Our operational team managed through this challenging period and were able to deliver approximately 400 of these 950 homes during the fourth quarter as operations return to normal.

Our gross margin on home sales in the fourth quarter was 22.4%, which was better than our stated goals. The prior year's gross margin percentage was 23.3%. The gross margins decline year-over-year was due primarily to increased land and construction costs, partially offset by an increase in average sale price. Sales incentives improved 50 basis points to 5.7% with the improvement driven by our Homebuilding West segment.

Gross margin percentages were once again highest in our Homebuilding East segment, and direct construction costs were up 7% year-over-year to approximately $57 per square foot driven by approximately an 8% increase in labor and a 6% increase in material costs.

Our SG&A percent continues to drive lower as fourth quarter was 8.4%. This was the lowest fourth quarter SG&A percentage in the company's history, and this compared to 8.7% in the prior year. The improvement was primarily due to a decrease in external broker commissions as a percentage of revenue from home sales and improved operating leverage.

Our operating margin for the quarter was 14%.

The joint venture, land sale and other category was a combined $12.4 million for the quarter compared with our guidance of $90 million to $95 million. This is the shortfall that we highlighted was attributable to the strategic transaction that will shift into the first quarter of 2018.

We opened 84 new communities during the quarter and closed 77 communities to end the quarter with 765 net active communities. New home orders increased 12% and the new order dollar value increased 18% for the quarter. Our sales pace was 3.2 sales per community per month, which was similar to the prior year.

Our dynamic pricing tool has enabled us to carefully manage our inventory again. And as a result, our completed unsold inventory decreased by 127 homes or 13% year-over-year to 848 homes despite an increase in homebuilding volume. This calculates to only 1.1 per community, which is our lowest level per community since 2012.

During the quarter, we purchased 8,200 homesites, totaling $647 million. We continued with our soft pivot strategy. However, this quarter, we did have some larger strategic purchases in the West region, and our homesites owned and controlled now total 179,000 homesites, of which 141,000 are owned and 38,000 are controlled.

Turning to Financial Services. This segment had operating earnings of $42.1 million compared to $51.4 million in the prior year. Mortgage pretax income decreased to $27.8 million from $36.6 million in the prior year. Mortgage originations decreased 9% to $2.5 billion compared to $2.7 billion in the prior year, while refinance volume was down 54% versus the prior year.

We have shifted to purchase business, which now represents 92% of our originations. The refinance drop has led to a more competitive origination and pricing environment. The capture rate of Lennar homebuyers was 80% this quarter compared to 81% in the prior year.

Our title company's profit decreased slightly due to the refinance contraction to $14.6 million versus $14.9 million in the prior year.

The Multifamily segment delivered a $38.6 million operating profit in the quarter, primarily driven by the segment's $43.8 million share of gains from the sale of two operating properties as well as management fee income, partially offset by G&A expenses. We ended the quarter with 13 completed and operating properties and 35 under construction, 12 of which are in lease up, totaling approximately 14,000 apartments with a total development cost of approximately $4.5 billion. Including these communities, we have a diversified development pipeline of approximately $9.1 billion and over 25,000 apartments.

Our Rialto segment produced operating earnings of $2.2 million compared to $8 million in the prior year, both amounts are net of non-controlling interest. The investment management business contributed $46.4 million of earnings, which includes $14.2 million of equity in earnings from the real estate funds and $32.2 million of management fees and other, which includes $10.9 million of carried interest distributions. At quarter end, the undistributed hypothetical carried interest for Rialto Real Estate Fund 1 and 2 now totals $119 million.

Rialto mortgage finance operations contributed $368 million of commercial loans into four securitizations, resulting in earnings of $14.3 million compared with $622 million and $35.6 million in the prior year. The decrease in earnings was primarily due to lower volume and lower margins, 3.8% in the current year versus 5.8% in the prior year.

Our direct investments had a loss of $20.6 million as we continued to make good progress on monetizing the remaining assets from the FDIC and early portfolio purchases. We have now reduced the remaining REO and loan assets in the FDIC portfolio to approximately $25 million at year end, and all of the remaining assets are under contract to be closing in our first quarter.

Rialto's G&A and other expenses were $31.6 million for the quarter and interest expense, excluding the warehouse lines, was $6.3 million. Rialto also ended the quarter with a strong liquidity position with $242 million of cash.

Our tax rate for the quarter was 34.7%. The rate is higher than the prior year's fourth quarter of 32.5% primarily due to additional energy credits recognized in the prior year. The tax reform bill will reduce our effective tax rate in 2018 from the current 34% to approximately 25%. Excluded from the 2018 effective tax rate is a one-time noncash charge of approximately $70 million to be recorded in our first quarter of 2018 related to the remeasurement of our deferred tax assets as a result of the new lower federal tax rate.

Our balance sheet remains strong with a net debt to total capital of 34.4%, an increase of only 100 basis points year-over-year despite acquiring WCI for $642 million in an all-cash transaction at the start of this year. Our liquidity strengths provide exceptional financial flexibility with approximately $2.3 billion of cash and no outstanding borrowings on our $2-billion revolving credit facility.

During the quarter, we redeemed $400 million of 4.75% senior notes that were due in 2017. And we also issued $300 million of 2.95% senior notes due in 2020 and $900 million of 4.75% senior notes due in 2027 to fund the cash portion in connection with the CalAtlantic merger and to the expenses related to the combination.

Stockholders' equity increased to $7.9 billion, and our book value per share grew to $32.81 per share.

Before I provide 2018 goals, I wanted to turn the call over to David Collins, our Controller and Chief Accounting Officer. He will be providing purchase accounting details starting in our first quarter for the combination with CalAtlantic. We felt this is a good time for him to provide you with a primer on the purchase accounting process.

So let me turn this to David.

David Collins: Thanks, Bruce.

As part of the CalAtlantic acquisition, we will be required to evaluate the assets and liabilities acquired and record them at fair value on the acquisition date, which is expected to be February 12, 2018. These adjustments will include, but not be limited to, adjustments to inventory, investments in unconsolidated entities, other assets, goodwill and debt. Certain of these adjustments will impact our gross margins going forward. There will be a more significant impact to gross margins from the acquisition date through the early part of Q3 2018 as a result of the backlog write-up that is required for homes that have already been sold.

The fair value of the assets acquired and liabilities assumed as well as the final purchase price, which is partially contingent on the value of Lennar's stock on the acquisition date, will impact the amount of goodwill recognized in the transaction.

We expect to have our provisional purchase allocation completed by the time we file our first quarter 10-Q in April of this year. The allocation is subject to change within a measurement period of up to one year from the acquisition date.

We look forward to updating you on our first quarter conference call.

Bruce Gross: Now I would like to provide some goals for Lennar in 2018. Note that we will update these numbers in March at our first quarter conference call to include CalAtlantic.

First, deliveries. We are currently expecting to deliver between 32,000 and 32,500 homes for 2018. We expect a backlog conversion ratio of approximately 65% to 70% for the first quarter, 75% for the second and third quarters and over 90% for the fourth quarter. We expect 2018 operating margins to match the 2017 level of 12.9%.

The full year gross margin is expected to be approximately 22% and SG&A approximately 9%. There will be seasonality between the quarters with the first quarter being the lowest operating margin and then improvement as volumes increase throughout the year. However, the quarterly year-over-year operating margins should be fairly consistent with the prior year.

Financial Services are expected to be in the range of $160 million to $165 million for the year. And the significant decline in refinance volume that impacted 2017 will continue to impact the first half of 2018 comparisons. As a result, first quarter and second quarter are expected to result in lower year-over-year earnings. However, we do expect to see year-over-year earnings for the third and fourth quarter to be higher.

Turning to Rialto, we expect a range of profits between $60 million and $65 million for the year. The second half of the year is expected to have higher profitability than the first half, and our first quarter is expected to be approximately $10 million.

Multifamily expects to sell seven to nine multifamily communities in 2018. However, these communities are smaller in size than the 2017 transactions.

This should result in a range of profits between $50 million and $55 million for the full year. The first quarter is expected to be just over breakeven, and then a small profit in the second quarter, and the significant portion of the profit in the third and fourth quarter.

The category Joint Ventures, Land Sales and Other Income, as we look at this category, we expect approximately $100 million of profit for the year, primarily coming from the strategic transaction that shifted from the fourth quarter to the first quarter of 2018. The quarterly breakout is approximately $80 million in the first quarter with the balance spread over the last three quarters.

Corporate G&A is expected to be steady as a percentage of total company revenues year-over-year as we continue to invest in technology initiatives. And as I mentioned earlier, our effective tax rate for 2018 will be approximately 25%, excluding the one-time $70 million noncash deferred tax asset charge. Our net community count is expected to increase approximately 7% to 10% from our ending count of 765, with the increased spreads throughout the year.

With our operating strategies and strong earnings contribution expected, we are well-positioned to deliver significant cash flow in 2018. The use of cash in 2018 will be prioritized to first reduce debt.

With these goals in mind, we are well positioned to deliver another strong, profitable year in 2018.

Let me now turn it back to the operator to open it up for questions.

Coordinator: Thank you. And we will now begin the question-and-answer session.

To ask a question, please press star followed by the number 1 on your phone.

To withdraw your question, please press star 2.

We would also like to remind the questioners to limit their questions to one and one follow-up question. Thank you.

And our first question comes from Stephen East from Wells Fargo.

Your line is now open.

Stephen East: No, thank you. Good morning, guys. I hope you can hear me okay.

Man: Yes.

Stephen East: I'm also at the Builders' Show.

So a ton of information here. So, I guess, the first question is when you look at the S-4 as you walked through all the $365 million of savings versus the $250 million, you explained a lot of what was happening. But what was in the $365 million that was not in the $250 million guidance?

Richard Beckwitt: I think -- Steve, it's Rick -- we were just being conservative as we were announcing the transaction to The Street. We're also very focused on other folks that might have an interest in doing the transaction. And we wanted to put on the table to our shareholders what we knew we could accomplish. And then since we had more detailed analysis, we knew there was upside.

Stephen East: Okay. I got you. All right. And then switching to the gross margin, cost up 8% in addition to labor being up 6% -- surprised me a little bit. I guess, was that primarily the land drive? Or what else was driving that and how the dynamic pricing play in the quarter, I guess, both from a gross margin perspective and the incentives level that you all reported?

Jonathan Jaffe: Hi, Steve, it's Jon.

The bulk of that cost increase is really lumber increases that had taken place earlier in the year but were flowing through our cost of sales. So lumber, both labor and materials associated with framing were up or made up 32% of that 8% increase year-over-year.

Stephen East: Okay.

Jonathan Jaffe: Lumber by itself was up 12% from June to September. You know, since then, lumber has moderated and we don't expect to see that increase continue, but that's the major driver behind that. And of course, flowing through margins as well as higher land basis and particularly, in some of our markets like in Inland Empire and Coastal California, so we do have that impact as well. Dynamic pricing, we're definitely seeing evidence that, that is, as we said earlier in the process, that's driving our incentives down, which is helping attribute to a positive impact on our margins.

Stephen East: Okay. And can you quantify that or do you want to try to quantify that for us?

Bruce Gross: So we did highlight that sales incentives have come down 50 basis points year-over-year. And that was driven by the Western region that was a little bit ahead in using the dynamic pricing tool.

Stephen East: Okay, got you. All right. Thank you.

Stuart Miller: And you'll continue, Steve, to see incremental improvement as our dynamic pricing tool becomes more and more understood and adopted throughout the company.

Stephen East: Okay. As you all look at it now, Stuart, how much do you think you can capture, say, like in the next year to bring down those incentives?

Stuart Miller: I knew that would be the next question. We're going to sit, wait and watch and see exactly where it goes. It's with all of these initiatives. They're hard to predict. Their timing is even harder to predict.

Stephen East: Okay.

Stuart Miller: We've got 33 divisions, each implementing, and it's somewhat of a dance. So we're looking at incremental improvement quarter by quarter. And I just think that with each new initiative, we'll see how high it can take us or how low it can take us and additionally what new increments we can start to bring to the table with new improvements. So I think there's a lot of room for improvement from all of these initiatives.

Stephen East: Okay. All right. Thanks a lot and great quarter on the core business there. Thanks.

Stuart Miller: Thanks.

Coordinator: Our next question comes from Carl Reichardt from BTIG.

Your line is now open.

Carl Reichardt: Good morning, everyone. Yes, so quite a fire-hosed conference call. Thank you.

Jon, I wanted to ask you about the direct cost reduction that you've called out when you look at the merger. What do you think the savings split would be between labor versus materials versus other elements? Where is the leverage greatest in your mind?

Jonathan Jaffe: Well, from a prioritization standpoint, it's going to be on the materials side. We're first going to attack national contracts. Labor, because of the labor shortage that exists out there, it's definitely high up on the priority. But it's going to take a little bit longer to get the trades converted over to the greater volume and in which trades have the ability to expand into that. But as you look at the actual math behind it, it's probably split pretty evenly between the two categories.

Carl Reichardt: Okay, thanks. And then, Rick, you were kind to talk a little bit about the changeover in the near-term communities for CAA. As you look at their longer-term land positions, what kind of flexibility do you have to alter product choice and then perhaps change mix over time? And I'm thinking about them being slightly more of a move-up focused than you, if I've got it right. Is there a chance that you could see more of that product move towards entry level as you bring it to market?

Thanks a lot.

Richard Beckwitt: So in the go-forward deals, certainly things that are platted or what have you, we have great flexibility in product selection. We got, in the Lennar world, move-up product. We have that in Village Builder brand and in our WCI brand. And there may be some CalAtlantic product that we ultimately convert to EI. So we have got great flexibility to do any and all. We, Jon and I, have spent a lot of time looking at individual deals, figuring out which ones we think we should increase velocity and put some lower-priced product in there. So you'll see us do all of the above.

Jonathan Jaffe: And I would just add that, as always, it's going to be a community-by-community, submarket-by-submarket analysis of what produces the best returns, both margin and IRR.

Carl Reichardt: Great. Thanks, guys.

Coordinator: Our next question comes from Ivy Zelman from Zelman & Associates.

Your line is now open.

Ivy Zelman: Thanks, guys. Congratulations on your quarter. You know what, and the detailed overview was extremely impressive. So thanks, Jon and Rick for that.

I guess, my first question, maybe, Jon, you can talk about, you know, the benefits of scale. I know when you're the largest builder, you said in over two-thirds of your market in at least Top 1 or 3 position. Assuming you get to see every land deal maybe before everyone else, can you walk through other benefits of scale? And then I have a followup, please.

Jonathan Jaffe: Sure. And we know this from the markets where we already have these dominant positions that, as you said, Ivy, first and foremost is access to the land market where we have a priority position there. Equally important is we have a priority position relative to the labor supply.

As you know from past conference calls, we have a very strong focus at Lennar becoming the builder of choice for the trade partners. And we've already seen a tremendous progress just based on Lennar's volume. The additional volume added to that that takes us to up that 125 million square feet I think is going to give us tremendous opportunity to truly become the builder of choice for the trades because we'll able to put consistent productivity in front of them, which is critical for their labor force to keep their piece workers focused on the job, building the same plans over and over. That's going to be a huge benefit for us.

Richard Beckwitt: And one last thing, Ivy, its people. When you have the biggest, best operating machine, especially on the sale side of the equation, people want to come and sell homes in that operation. So we attract great new home consultants in the organization.

Jonathan Jaffe: And I would just add, too, because - as we've talked a lot about on our calls, our focus relative to marketing and really the success we've had with social media and our online presence, that's going to be a tremendous leverage opportunity for this additional scale at almost no additional cost to be able to do the digital marketing effort that will bring in high-quality customers at even lower and lower costs.

Ivy Zelman: Great. That's very helpful.

The second question, as you talked - Jon, you mentioned the opportunity for backward integration, concrete block, framing, panelization, et cetera. Maybe you can just take one of those as an example. I'm sure you've looked at the investment and the return - and the impact to profitability that you may derive from that type of backward integration. And I know it's a lot, but maybe even the timing with the combination, obviously, only being finalized in February. Is this something that you'd think about in a few years or could it be sooner?

So a lot there, but appreciate any response. And congratulations on the quarter again.

Jonathan Jaffe: Thank you.

Ivy, it's a little bit longer on the time horizon just because it's - we're going to have to approach it carefully where we definitely are deep into the thought process.

If you look at Florida, as an example, we're going to build 15,000 homes in the State of Florida. There's tremendous opportunity with that scale to have activity in Florida that's vertically integrated. We will, you know, determine what those values are, and that will really create the prioritization of what goes first, whether it's concrete block in Florida, whether its truss plants in Texas. Those are things we definitely will get to and work is underway. But it's really premature to talk at any more detail right now.

Richard Beckwitt: I think what you'll see, Ivy, is we'll probably do some sort of mutual arrangement with someone to get in. And then as we understand the dynamics and the pricing of the business and flow-through, you'll start to see us do something on a standalone basis.

Jonathan Jaffe: And I'd just remind you, Ivy, that we have Paul Dodge heading up this whole effort. He's been on both sides of the equation. He's been on the supplier side as well as the builder side. So we have a good understanding of all aspects of what it'll take to accomplish this.

Stuart Miller: So the focus…

Ivy Zelman: Good luck, guys.

Stuart Miller: … - yes. Just to finish up, Ivy, the focus has been squarely on driving the greatest savings through our cost structure. We're starting with the lowest-hanging fruit. It's going to be in and around the material side of the business and national contracts. Probably the next level down is in and around local labor. The consolidation and becoming the largest concentrated local builder is really important in terms of consolidating the attention of the labor force. And this is going to be a big benefit and a strong local focus. So to us, that's kind of the second tier of low-hanging fruit.

As we get to a third tier - and Rick, Jon and myself have been looking strategically at how we think about some elements of vertical integration that can change the way that we look at the building industry as we develop this core scale in each local market. Rick highlights in Florida we'll be building 15,000 homes. That's scale. That enables us to do and look at a lot of things that we haven't been able to look at before in an economical way. And these will be drivers of savings at a third tier as we go forward.

When we talk about these various tiers, I hope you're getting the sense that the integration process and the focus is happening very quickly. The lowest-hanging fruit will be incorporated at the very beginnings of this combination. The second and third level will come quickly behind.

Ivy Zelman: No, that's extremely helpful.

Just a quick sneak in…

Ivy Zelman: …Jon, you mentioned digital - I'm sorry, digital marketing. And can you talk about how many hits a week or how successful you see from that initiative?

Jonathan Jaffe: I think the metric we look at as most impactful is the number of leads we get from that. That's people who actually ask for information. So versus hits, which is hard to tell, you know, what that leads to, but leads are people who are interested enough to ask for information. We are continuing to generate over 100,000 leads per quarter from our social marketing outreach program.

Stuart Miller: And let me just say parenthetically, from our viewpoint, the numbers that we're producing are impressive. We view ourselves as being in the very first inning of digital marketing and what we can do with it. So we are very focused on getting better and better at targeting and engagement. And we think that we can create a great digital conveyor belt of customers that are interested in our products. So, there's more to come in this arena.

Coordinator: Our next question comes from Stephen Kim from Evercore ISI.

Your line is now open.

Stephen Kim: Yes, thanks very much, guys. Hopefully you can hear me well. I'm also at the Builders' Show.

You laid out some pretty impressive initiatives that you had been taking to try to get ahead of the integration. I guess I was curious as to whether any of that has spread over into the land side of the equation. And if you could talk a little bit about what you envision for land spend for a larger organization given some of the overlapping in existing markets that you will have, just if you could just comment on what you expect from the land spend side in terms of expectations, different from maybe Lennar standalone.

Richard Beckwitt: So, Steve, I'm not really prepared to give you a dollar amount yet because we're culling through that now. But I can tell you that our entire organization from a division president, regional president, land acquisition teams are totally coordinated on the opportunities to drive growth.

What makes deals successful, as Stuart has highlighted in the past, is, number one, integrating the operations and becoming one company; number two, going after that low-hanging fruit; and number three, keeping machines going and growing. And where deals pause and stall out is because they're not focused on all of those aspects of the business.

So as I highlighted in my commentary, we've gone heavy in purchasing personnel and heavy in land acquisition personnel and development personnel because that's the future of the company. We are - Jon and I are reviewing the significant deals. Our regional presidents and division presidents are isolating those transactions, maximizing absorptions and pace and looking at value enhancement in each one of these deals.

Jonathan Jaffe: Steve, its Jon. I would also add that as we look at the process of integration, we have prioritized land acquisition as the absolute top priority from the perspective of analytics, underwriting tools, approval process, so that we can hit the ground running and not skip a beat in terms of giving our teams, our operational teams out in the field, the clarity of how they will go about executing the acquisition game plan.

Stuart Miller: You know, and let me just add as an overview here, Steve. I don't want you to think of Jon and Rick's primer or overview on integration as a group of initiatives. These are action plans. And the action plans have been constructed. They are being put in place. And I think that, you know, not skipping a beat is our primary focus right now.

As it relates to land, there are land plans and land expectations being consolidated and put together at each divisional level. And it's a primary focus as to exactly how many dollars we're going to be spending over the course of each next year in order to maintain the trajectory that's expected.

We'll give better ideas of consolidated numbers after we close the transaction. Hopefully, we've been able to convey to you that we're not waiting to close to come up with a plan. The plan is going to be well in place to be enacted the day we combine.

Richard Beckwitt: And one last point. And that is we're benefiting from just tremendous cooperation and professionalism from Scott, Larry and Pete. They are sourcing these opportunities. They're bringing them to our attention. They're out there actively looking to help the pro forma company to grow. And we couldn't thank those guys enough for their leadership throughout this whole process.

Stephen Kim: Great. No, that's very helpful. And it kind of gets - it serves as a segue to my next question, which is looking a little bit more at the construction in progress side of the equation. So, I guess, first, kind of a two-part question, the conversion to Everything's Included, this is something, you know, you've done before, actually. And I was curious if you could share with us how long do you think it takes as, you know, to sort of make a conversion from design studio to Everything's Included. Is there a learning curve, for example, with trades or with your supervisory staff? You know, are there sourcing contracts that have to expire first which need to be integrated into Everything's

Included? You know, those sorts of details, if you can just give us a sense for how long the conversion to EI takes.

And then sort of a second question kind of embedded is I know there's a lot of concern on the part of investors to largely believe that you will be able to integrate CalAtlantic effectively. I'm just being a little concerned about the timing, the year, the time of year, you know, the spring selling season, you know, where you really need to get all your ducks lined up in a row. You've shared a lot, which gives us some comfort that you're not going to be caught off guard there. But just if you could put maybe, just specifically address anything that you're doing, recognizing that this is a super important time of the year to be going to market and going out with a bit of a unified strategy.

Stuart Miller: Steve, let me start off. And just an overview, Jon's going to try to fill in some of the blanks.

But, you know, in combination and integration, you've seen some of this with WCI. This is not an arbitrary race to get something done. This is an orderly strategic process of making sure that we keep the racecar on the track and we make the changes incrementally as they are most effectively implemented.

There is a differential between existing product and product that is to be started. And on existing product, there is a difference between communities that are just finishing up versus those that are just getting started.

So the process of actually implementing Everything's Included is something that's going to be a part of an orderly process as it has been in the past.

Jon?

Jonathan Jaffe: So it starts with a game plan, community by community, that we'll look at. And Rick was highlighting some of this in his comments to which communities it makes sense to leave as the existing CalAtlantic product and build through and finish them out in their design studio format, and then which communities does it make sense and when to transition over to Everything's Included product.

Now to your question about how difficult that is, that Everything's Included project is already existing in the Lennar portfolio, right? It's not something we have to create. We know it, and we know in each market. Now remember, one of the strategic reasons we are really excited about this combination is its markets we know and its products we know. So we know the products. We also know the Everything's Included levels in those markets. We've done that research. And so that will be a consistent, somewhat seamless transition to just put the Lennar product and the EI package on an existing CalAtlantic community.

So, some will continue out as appropriate to finish out as CalAtlantic product, and then bulk of the transition you'll see in the second and third quarters where we switch over to EI product. It's my expectation that as we turn the corner into 2019, virtually 100% of our starts will be Everything's Included product or under the Village Builder or WCI brands.

Richard Beckwitt: And, Steve, one final point is I think it's important for you to realize that we really only have two markets in this whole operational - operation combined that have never done EI. That's Salt Lake City and its Indianapolis. In all of the other markets across the nation, we've got personnel that know how to do this, know how to design it, know how to build it, know how to source it, know how to purchase it. So it's - this is not a new thing.

Jonathan Jaffe: Not only that. It's Jon again, obviously. Those divisions - all divisions are supported by regional presidents that know this product and market, with obvious exception of one CalAtlantic regional president that's coming over. But he and all the other regional presidents will be supported by purchasing teams, national and regional, marketing teams, national and regional, that really know our Everything's Included platform inside and out.

Stuart Miller: And look, as a - just as a followup, Everything's Included is not - it's not an easy thing to just adapt or adapt to or adopt. We've seen a number of builders try to copy what we do. It's a process. It's a process on the sale side. It's a process on the production side. There are learned behaviors. They will be implemented and learned over time. Everything's Included is an attractive program. It's a marketing and production program. It's attractive because it really has big benefits on the production side. It'll take some time. It'll take some learning. But we're very confident that the implementation will be orderly.

Stephen Kim: Great. Thanks, guys.

And what about the spring?

Jonathan Jaffe: What do you mean, Stephen, what about the spring?

Stephen Kim: Just, you know, just is there anything particular that you are doing or are planning to - that reflects just some of the challenges of entering the spring selling season as opposed to, let's say, doing this at a later time in the year maybe where the industry isn't quite so much gearing up with generally a much more aggressive posture? I was just curious if there's anything about the spring that affects the way you go and approach the integration.

Richard Beckwitt: Yes. So, Steve, I think that really gets to the importance of this master construction agreement that we signed with CalAtlantic. We have, in 42 communities across the country, already permitted and starting homes right now that's Lennar brand. This has never been done in the M&A business.

Stuart Miller: Yes. And let me say as it relates to the spring, Steve, I think that the single most important thing is at each community level that there'd be certainty, okay? The communities are already purchased. The product is pretty much in place. We're not going to cloud the spring selling season with a lot of uncertainty. The mapping of exactly what each community is going to be doing is already being set out. As we enter the spring selling season, there will be certainty at each community level. And we'll be prepared for the spring, if that's the question.

Jonathan Jaffe: And just one more comment, address this to your question, but I think, really, all of these questions. We are already commencing what we call community operations reviews. So our management teams, the new combined management teams are going around every community, meeting with the sales team in that community, construction team, the customer care team, to understand exactly where that community is, really confirm the roadmap and make sure everyone is on the same page, everyone is rowing in the same direction.

Stephen Kim: Yes. That's really impressive. Really appreciate it. Thanks, guys.

Stuart Miller: You bet.

Why don't we go with one more question?

Coordinator: Our next question comes from John Lovallo from Bank of America.

Your line is now open.

Peter Galbo: Good morning, everybody. This is actually Pete Galbo on for John. Thanks for taking the question.

Bruce, I think you mentioned an 8% increase year-over-year on labor costs. And that was, you know, up from the 5% you mentioned in 3Q. I was just wondering if there's anything more in that outside of, you know, the disruptions from the hurricanes pushing up labor cost or any other material changes happened in the quarter.

Jonathan Jaffe: Yes, it's Jon. I'll take that.

So I said that the bulk of the increase even affecting the labor side is happening in the framing component. There's nothing unusual, that I would say and even relative to the hurricanes. There is, you know, some trades here or there that have increased prices relative to that as they get pulled into the repair business. But by and large, it's just a continuing trend of the labor constraint against a - improving homebuilding environment.

Peter Galbo: No, I appreciate that. And, again, appreciate all the color on the talking integration.

I guess, you know, Stuart, just taking a higher, you know, 10,000-foot view here, you know, you now have two builders that are effectively double the size of your next largest competitor. And I'm just wondering how you guys are thinking about, with everything else that's going on, how you're thinking about, you know, how your competitors may respond, some of the smaller competitors may respond to changing dynamic that you guys have kind of set out here on.

Stuart Miller: I think that the way we're configured, we have our eyes squarely focused on our business. And we're not all that focused on the competitive response. As you come around the halls of Lennar, you will see that we are very independently focused on how we're configuring our company for the future. It's not just this combination and the seamless execution that we expect of ourselves. It's not just preparing for a spring selling season, making sure that there's certainty at the division and at the community level with product in place and ready for the spring selling season. It's also about the number of initiatives that we have on track concurrently, even while we are integrating, focusing on our digital marketing strategy, enhancing beyond 100,000 leads per quarter to something much greater than that. It's about a dynamic pricing tool that is going through implementation at just Lennar divisions and ultimately combined divisions that will redefine the way that our business operates, driving SG&A lower and profitability higher.

We are thinking way outside the competitive landscape box to think about how we can - I've said it over and over again, how we can build a better mousetrap.

And so the competitive response from the rest of the market is of less consequence to us than how we can vertically build a better program that is something that the homebuilding world hasn't yet seen. And we think that the key to the kingdom for us is, in large part, this local concentration and scale, the ability to build that concentration and to rebuild both production lines, sales approaches, marketing approaches and internal operations to build a better program for homebuilding going forward.

So that's kind of how we're thinking about it from 10,000 feet.

Jonathan Jaffe: And in supporting that, supporting Stuart's comments on what we see in front of us, this is something that's not so obvious to everybody, and that is the people and the culture at Lennar. And what we have is a group of people that are really enthusiastic and excited about these challenges and opportunities in front of us that are welcoming and looking forward to the CalAtlantic associates to joining their teams. And there is just overall enthusiasm about what we're taking on and the opportunities.

Stuart Miller: All right. So, listen, in conclusion, I just want to thank everyone for joining us. I think that you can see that we've been very focused on integration, focused on our business, and we'll continue to be that way.

I do want to say, you know, as a parting comment on this call that the efforts that we've articulated have been efforts around both companies. And the tireless work of Scott and Larry and Pete, especially Jeff McCall, who we haven't even mentioned yet, and the many, many associates of CalAtlantic that we look forward to getting to know better and work with, it's just been a very impressive and - partnership to build the business platform as we go forward.

We're really enthusiastic about this combination. We're enthusiastic about what it does for us in the short term and where it can take this company in the long term. And, you know, as Scott Stowell joins our Board of Directors and as we begin moving forward, we're just - we're very enthusiastic about the business. And I think that's come through on this call.

So thank you for joining us. We look forward to giving you future updates as we close this combination on February 12, as we continue to integrate and ultimately, as we report quarterly progress going forward.

Thank you.

Coordinator: And that concludes today's conference. Thank you for your participation. You may now all disconnect.

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