Public Homebuilders Look to Build in 2010

BY BRIAN J. CURRY, CRE, MAI, SRA

PUBLICLY TRADED HOMEBUILDERS, many of which were "sellers" of production housing lots in 2007 and 2008, have again become "buyers" in certain markets around the country. Residential development land was often characterized as an investor/speculator acquisition market as late as the winter of 2009. Publicly traded homebuilders have since re-entered some markets, often with very aggressive purchasing strategies that have left investors and non-publicly traded private builders (those few with the financial horsepower) unable to compete.

In many of these markets, profit margins, expressed as a percentage of sale revenues, must be below ten percent to consummate a transaction that has multiple bids from builder competitors. Such narrow profit margins often imply non-leveraged yield rates (internal rates of return) at twenty percent or lower. These profit and yield hurdles are similar to those during the housing boom of 2003–2006.

The *NAHB/Wells Fargo Housing Market Index* (Figure 1) gauges builder perceptions of current single-family home sales, prospective buyer traffic and sales expectations for the next six months. Builder perception, or confidence, of near-term sales conditions affects decisions to acquire lots and construct homes. Builder confidence bottomed out in January 2009 at levels not seen in more than 25 years. The recent increase would signify growing optimism on the part of some builders going into 2010.

Recent or pending public homebuilder acquisitions are reported around the country but are focused mainly in first-tier locations in regions such as California, Arizona, Texas and Florida. To limit risk and keep lot inventories in check, structured rolling option contracts are preferred by buyers. However, larger bulk purchases, typically lender real estate owned (REO) assets, are also in play.

Some investor/speculators were having second thoughts on their gamble in picking up lots at discounted prices in 2007 and early 2008 given the subsequent credit collapse in the fall of 2008 and dismal winter of 2009. Some are now in a position to sell the same lots to public builders for an attractive return rather than the anticipated three- to five-year holding strategy.

Since public builders are indeed in the home-building business, lots are being acquired to build rather than bank. Construction critical paths suggest these markets will see new for-sale housing in the summer of 2010 if not sooner. This scenario, where new home construction will find adequate demand for market entry in 2010 was, for the most part, not considered realistic in 2008 and

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Figure 1

NAHB/Wells Fargo Housing Market Index

Source: National Association of Home Builders - Economics & Housing Policy

early 2009. Indeed, in certain markets, new home construction and sales in existing developments have accelerated because of the lowering of home prices by those builders willing and able to do so.

New construction is feasible provided product is priced to capture demand (absorption), and the cost to acquire lots, build and then sell homes is low enough to allow for an adequate return. An examination of pricing and inventory trends along with effective demand factors are critical criteria to the feasibility equation.

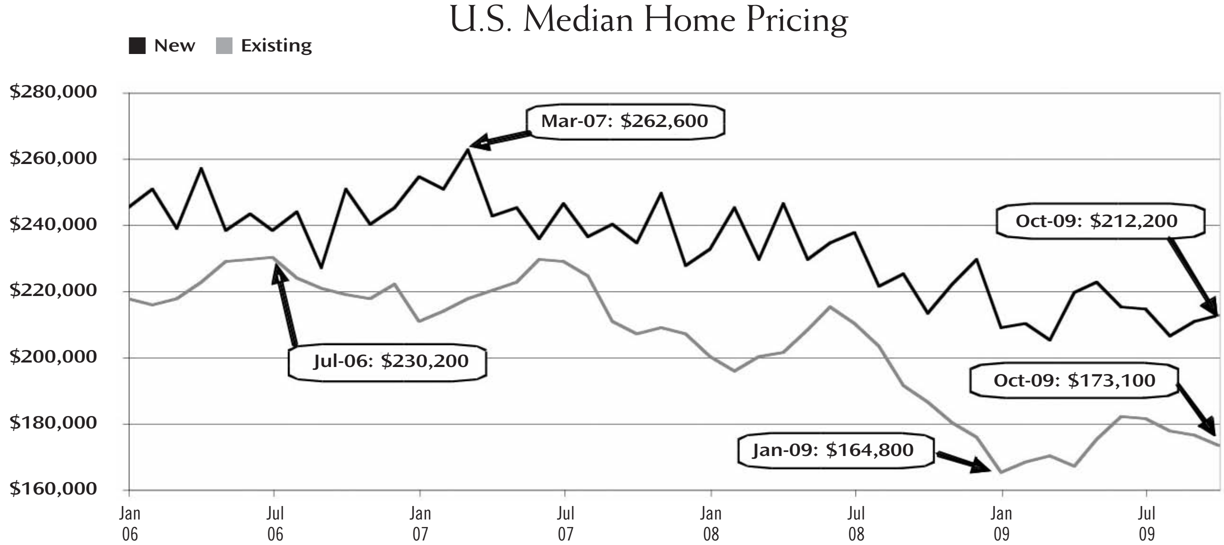
HOME PRICING TRENDS

According to U.S. Census Bureau statistics (Figure 2), the U.S. new home median price reached an all-time high in March 2007, followed by the most severe price decline in more than 50 years. A low of $206,200 was recorded in August 2009, reflecting a 21 percent drop from market peak, followed by slight increases through October. Median new home pricing has returned to 2003 levels.

The National Association of REALTORS® (NAR) reports the U.S. existing home median price reached an all-time

Figure 2

U.S. Median Home Pricing



Source: U.S. Census Bureau and National Association of REALTORS®

high in July 2006 and has also declined precipitously (Figure 2). A floor may have been reached in January 2009 at $164,800, reflecting a 28 percent decline from the peak. Pricing increased more than 10 percent from January through June 2009, but has since declined to $173,100 through October 2009. Like new product, median existing home pricing has returned to 2003 levels.

In the current market, it is often the case that the resale market is the primary competition to new construction rather than builders competing with builders. This is especially true for infill locations with limited potential for new home construction. A general consensus among homebuilders is that in markets with low or limited supply of buildable lots, new product priced at or slightly above existing homes will find market acceptance as many homebuyers prefer new homes and will pay a premium over resales, which may involve dealing with foreclosures and short-sales.

NEW HOME INVENTORY TRENDS

In 2005, inventory levels began to increase companion to the declining rate of home sales. According to the U.S. Census Bureau, new home inventory reached an all-time high in 2006, but has since decreased 58 percent to 1992 levels with the decline in construction. Supply reached a 35-year high of 14.3 months in January 2009 as new home sales hit a 35-year low (Figure 3). An increase in sales rates, coupled with the lowest year-to-date completions on record, helped lower new home supply to 6.8 months by August.

Building permits are an indicator of near-term future construction (Figure 4). New home sales peaked in 2005, and building permits began to decline four months later. Building permits in 2008 dropped to an all-time low (since recording began in 1959), reflecting a 58 percent decline from the high in 2005. January 2009 marked the lowest monthly permit activity (36,300) on record. As of October, permit activity was more than 47 percent below 2008 levels.

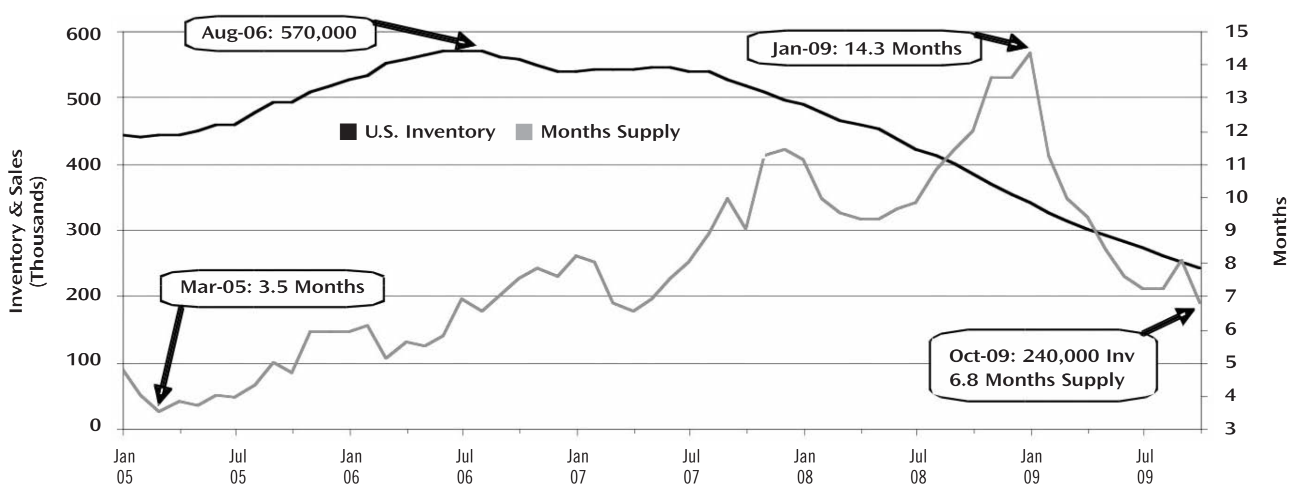
Low inventory of new construction is the significant impetus for the most recent purchasing strategy by builders. With limited new supply entering the market in the short term, those builders able to control lots in select locations with limited supply have greater confidence in the ability to sell product when primary competition comes from the resale rather than new home market.

EXISTING HOME INVENTORY

Existing home inventory is critical to the feasibility of new construction as it presents competition and also demonstrates the health of the housing market in general. Further, the ability to move up or move down equity out of existing homes is significant relative to the ability to sell new housing. According to the NAR, existing home inventory peaked in July 2008 and has fallen 22 percent, bringing the supply down to 7.0 months from the high of 11.3 months

Figure 3

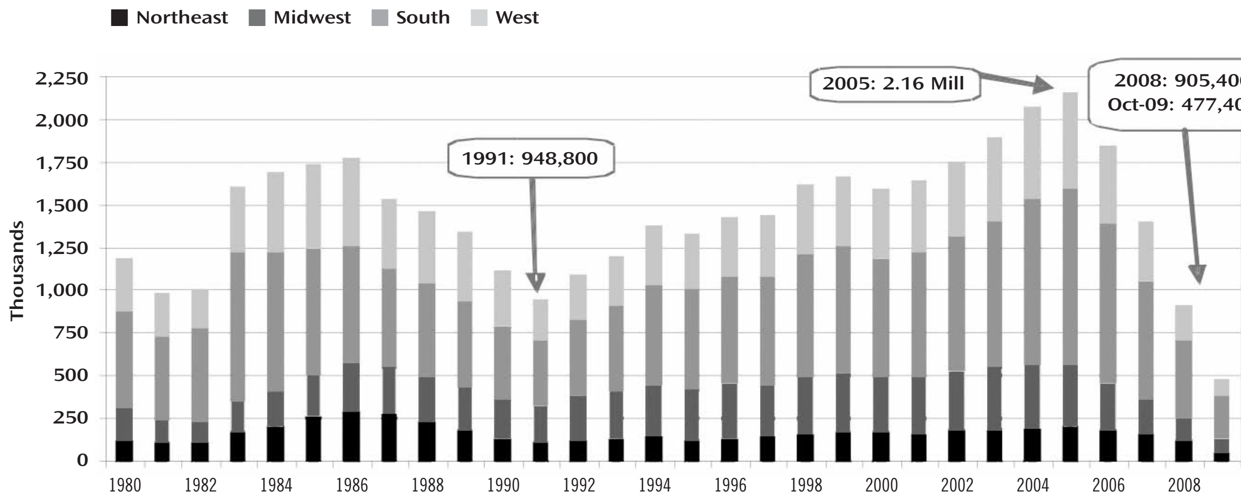
New Home Inventory



Source: U.S. Census Bureau

Figure 4

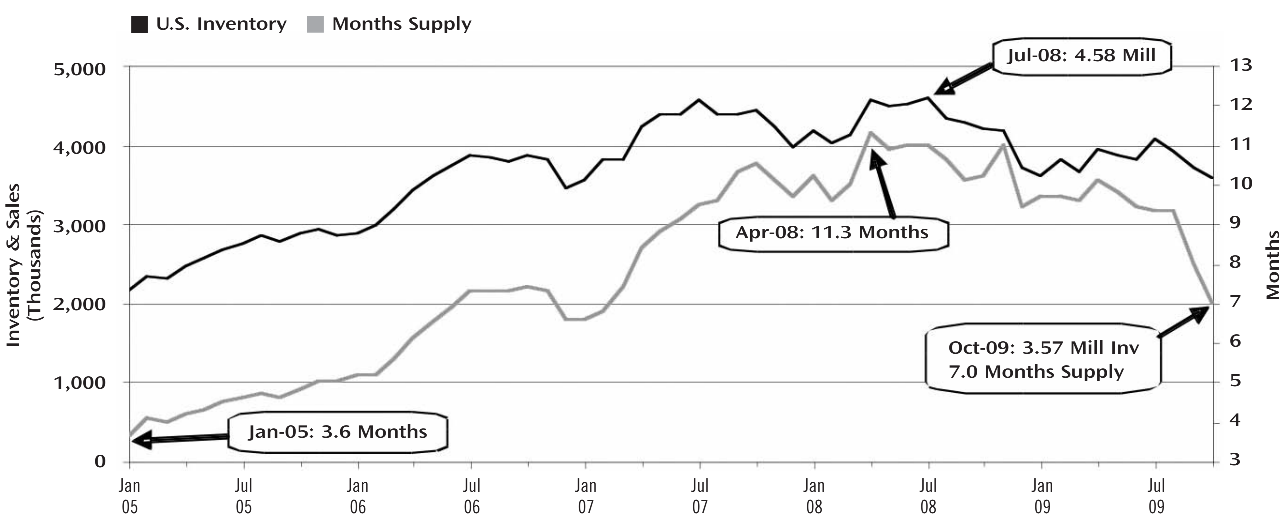
New Home Building Permits



Source: U.S. Census Bureau

Figure 5

Existing Home Inventory



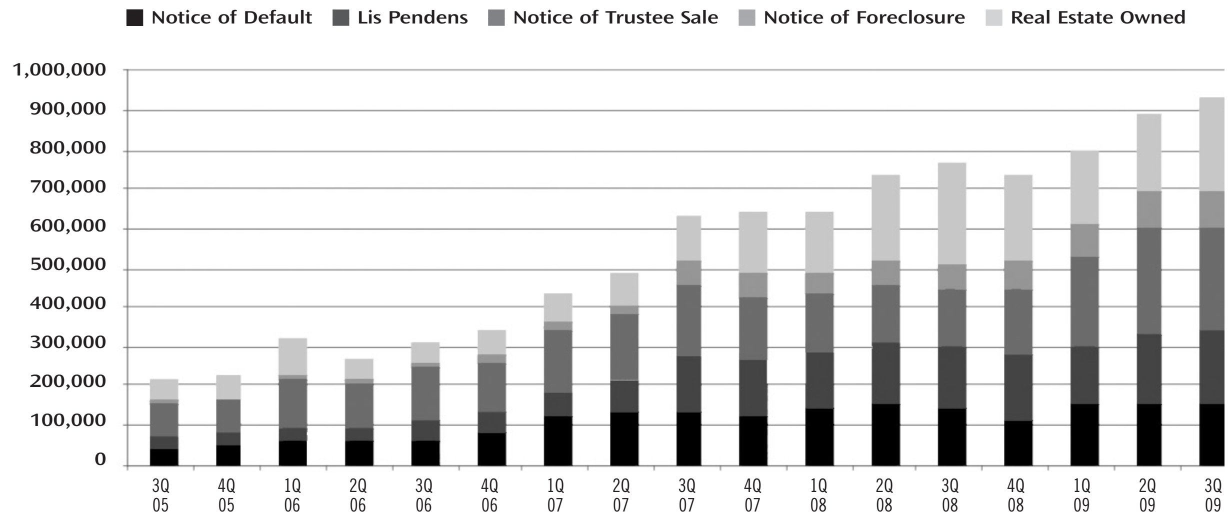
Source: National Association of REALTORS®

in April 2008. Increased sales activity and lender delays in taking back and then selling additional REO inventory has helped lower existing home supply (Figure 5).

Even so, foreclosures have exacerbated the downward trend in pricing and continue to put upward pressure on existing inventory. *RealtyTrac* reported 1.3 million foreclosure filings in 2006 (Figure 6). With the subprime crisis unfolding in mid-2007, a 75 percent increase in foreclosure filings was recorded by year-end. Foreclosure filings rose to 2.9 million in 2008, a 43 percent year-over-year increase. As of third quarter 2009, year-over-year foreclosure filings were 23 percent higher than 2008. This increase has likely been subdued by lender delays or government imposed moratoriums on foreclosures. Hence, the rate of foreclosures has not kept pace with

Figure 6

U.S. Foreclosure Filings



Source: RealtyTrac

notices of default. *Housing Predictor* estimates there were 4.2 million residential foreclosures from 2007 through June 2009. More than 5.8 million additional foreclosures are forecast through 2012. If the projections are accurate, there will have been 10.0 million foreclosures over a six-year distressed housing cycle ending 2012.

EMPLOYMENT AND PURCHASING POWER

The Bureau of Labor Statistics reported that non-farm employment peaked in December 2007 and has declined 5.2 percent as of November 2009, reflecting a loss of approximately 7.2 million jobs. Unemployment has surpassed 10 percent. It does appear that the rate of job loss has finally been curtailed, but robust job growth is not anticipated for several years. Unemployment and fear of additional job loss and wage compression will continue to keep significant demand in check, even as some sectors of the economy begin to show improvement and the statistical recession is reportedly over or waning. It is difficult to conjecture the overall effect of a so-called "jobless" recovery on the housing market when, in traditional economic-housing cycles, employment is the primer of housing demand.

As of November 2009, Freddie Mac reported fixed-rate 30-year mortgages were averaging 4.88 percent, slightly above the 40-year low of 4.81 percent in April. Low interest rates have dramatically increased affordability levels and rates are not anticipated to increase substantially in the short term. However, long-term forecasts are for increasing interest rates along with potential hyper-inflation. Further, qualifying and underwriting continue to present a major barrier to purchase mortgage financing. If and when interest rates do increase, affordability levels would diminish accordingly and reduce housing demand.

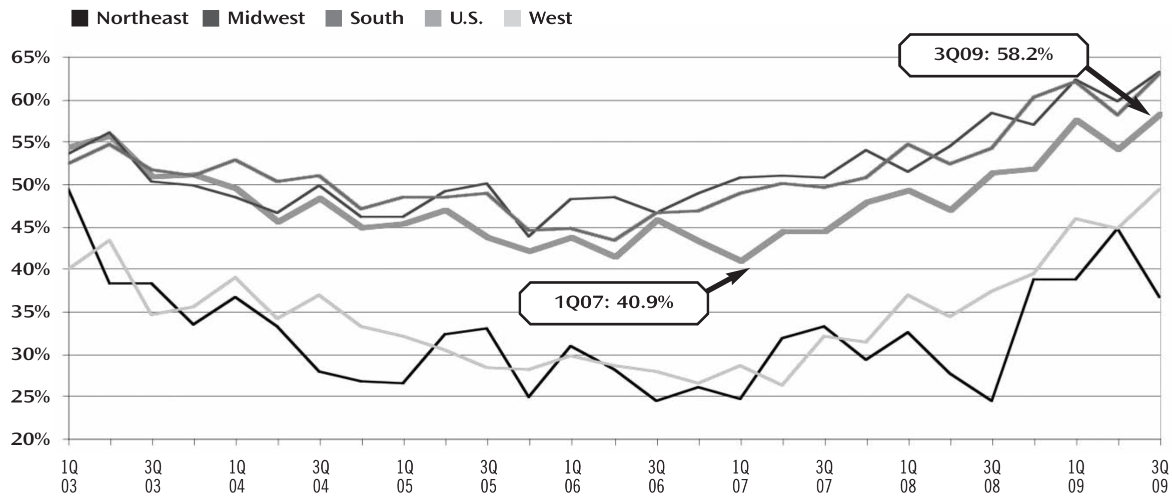
LOOKING AHEAD

Debate continues with regard to the health of the economy and housing market. Home prices have decreased substantially over the past 24 months, and home purchase affordability indices are at new highs (Figure 7). Government intervention, in the form of first-time and move-up homebuyer tax credits, Home Affordable Modification Program, the recently introduced Deed-For-Lease Program, exceptionally low interest rates, and financial support of FNMA and FHA, has helped sustain demand for home purchases. On the other hand, economic instability reflected in yet-to-be-realized employment growth, and staggering statistics on the potential for new increases in foreclosure inventories instills pessimism as to whether the housing market has indeed hit a true bottom in this cycle.

There have been various articles in the press and economic studies suggesting "guarded" optimism that the housing market had reached bottom, with positive movement in pricing and sales. Even so, most considered

Figure 7

New Home Affordability



Source: Hanley Wood Market Intelligence

a "U" rather than "V" shaped recovery the likely prognosis. There have been more recent articles and studies suggesting the potential for renewed downward movement in home prices which would imply a "W" shaped recovery is possible.

Public homebuilders buying highly discounted lots hope to build and sell product while navigating erratic and often conflicting economic and housing metrics. During the boom years, when price appreciation was the norm, it was not difficult to cover aggressive acquisitions regardless of the underlying metrics. Today, current conditions—much less forward-looking projections—are less clear. With an improving economy and positive movement in the housing market, bulk purchases of production lots may prove profitable and put the pessimistic forecasts to bed. Alternatively, further softening in home prices and demand could put aggressive pro formas with narrow return criteria at risk, and should the housing downturn continue unabated, those same builder/buyers may become sellers once again. Builders with rolling option lot take-downs will have the flexibility to react accordingly. ■

Editor's Note: portions of this article appeared in PricewaterhouseCoopers' Korpacz Real Estate Investor Survey™ Fourth Quarter 2009.