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Americans are Leaving High-Priced Housing Markets: What Should Builders Know?

Building with Southern yellow pine gets tricky in Texas, where high humidity causes the wood to bow. Fir doesn't have that problem—but it also costs more.

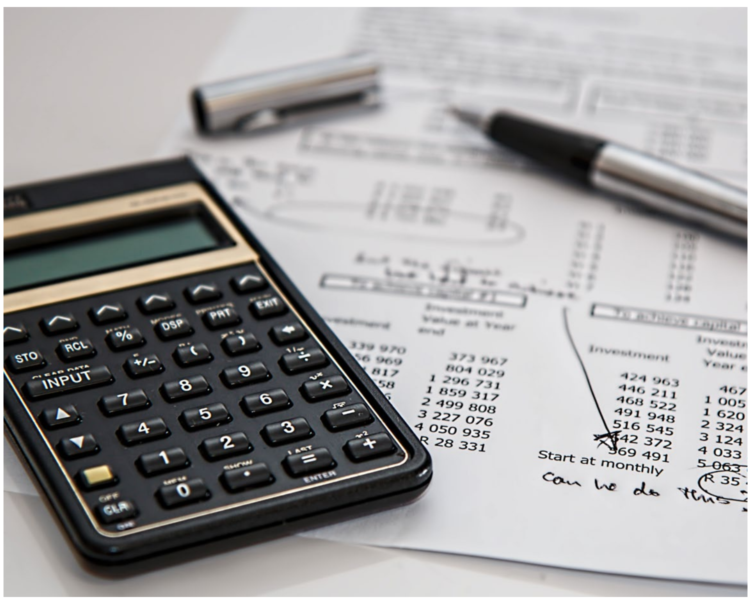
That's just one example of the tough decisions home builders like Eddie Martin, president of Tilson Home Corporation, are having to make to stay competitive in today's housing market. Martin's company, which builds about 400 homes a year throughout the Lone Star State, has already had to reduce its floor plan options. Now they are looking at the materials being used in their overall building package for ways to scale back or offering fewer options in an effort to help offset the skyrocketing cost of building new homes.

> "It's imperative we keep our prices in the range where we can sell the house," says home builder Eddie Martin.

It's the great irony of the post-recovery housing market: Despite home prices soaring nearly 50 percent since 2012, homes are growing more affordable for buyers. On the construction side, however, building a home is anything but affordable, and it's only getting tougher.

Thanks to low unemployment and strong wage growth, more than 61 percent of homes on the market are now affordable for families earning the median U.S. income of $71,900—which itself grew a stunning 5.7 percent over last year, when just 59.6 percent of homes were within reach of buyers. This newfound wealth has helped fuel a mounting demand for upwards of 1.3 million homes. But despite the ready market of hungry buyers, builders are struggling to keep up. Overall home construction dipped 3.7 percent in April, and building permits fell 1.8 percent to a seasonally adjusted 1.35 million as builders grappled with rising costs and other factors that continue to constrict supply.

"Continued job growth, rising wages and strong consumer confidence are fueling housing demand. In turn, this should lead to more buyers entering the housing market in the coming months," say home builder Randy Noel, chairman of the National Association of Home Builders (NAHB). "However, builders continue to face headwinds that could impact affordability, including chronic labor and lot shortages, rising prices for building materials and excessive regulations."



Rising construction costs

Hikes in building costs over the past several years have caused profit margins to slim, putting the squeeze on many builders.

The average single-family home sold for $427,892 in 2017, netting builders less than $46,000 in profit. The rest went primarily toward what NAHB chief economist Robert Dietz calls the "three L's"—lots, lumber and labor. These costs form the cornerstones of a home's sale price, and their astronomical growth in recent years has made it less and less economically feasible for construction companies to build the entry-level homes buyers are clamoring for.

More than 55 percent of a home's final sales price typically goes to construction costs, while finished lot costs account for more than 21 percent. Both costs consume a noticeably bigger share of the sales price than they did in 2015, thanks to lot scarcity, labor shortages and rising material costs. For example:

- Tariffs on Canadian lumber have driven up framing costs by as much as 31 percent adding an estimated $6,000 to $10,000 to the cost of a median-priced home.
- More than 1.5 million residential construction workers have left the industry since the recession causing at least half of builders to report a serious shortage of tradespeople last year.
- Vacant lots have dwindled more than 20 percent since 2011 in major housing markets, driving median lot prices to record highs.

"You've got the kind of perfect storm brewing for the home builder," says Jim Barbes, vice president of national sales at 84 Lumber Company, one of the nation's largest building-supply chains.

A new way of building

At a factory in Baltimore, computer-powered robots build prefabricated walls for new-home construction. They slice wood to exact length, nail studs together at precise intervals, and add wiring, pipes, windows and insulation. It takes about a day for the machines to frame out a home. The pieces are then hauled to the construction site and assembled over several days.

The process, used for decades in Europe, requires only a fraction of the labor and can cut construction timelines in half. It's just one of the many solutions builders are turning to as they seek new ways to put a lid on burgeoning building costs. From factory-built frames to brick-laying robots, new construction technologies have emerged to help take the pressure off home builders—and they're changing the way contractors build homes. As many as 20 percent of houses could be prefabricated within the next five years.

"We're at a tipping point where it's finally just gotten too expensive to build the old-fashioned way," says Margaret Whelan, CEO of Whelan Advisory and an investment banker for the home building industry.

If builders want to maintain their profit margins in the face of rising building costs, they need to innovate and adapt. That could mean anything from devising new business models to completely revolutionizing the way they build.

Here are some of the ways builders are changing in response:

Think smaller

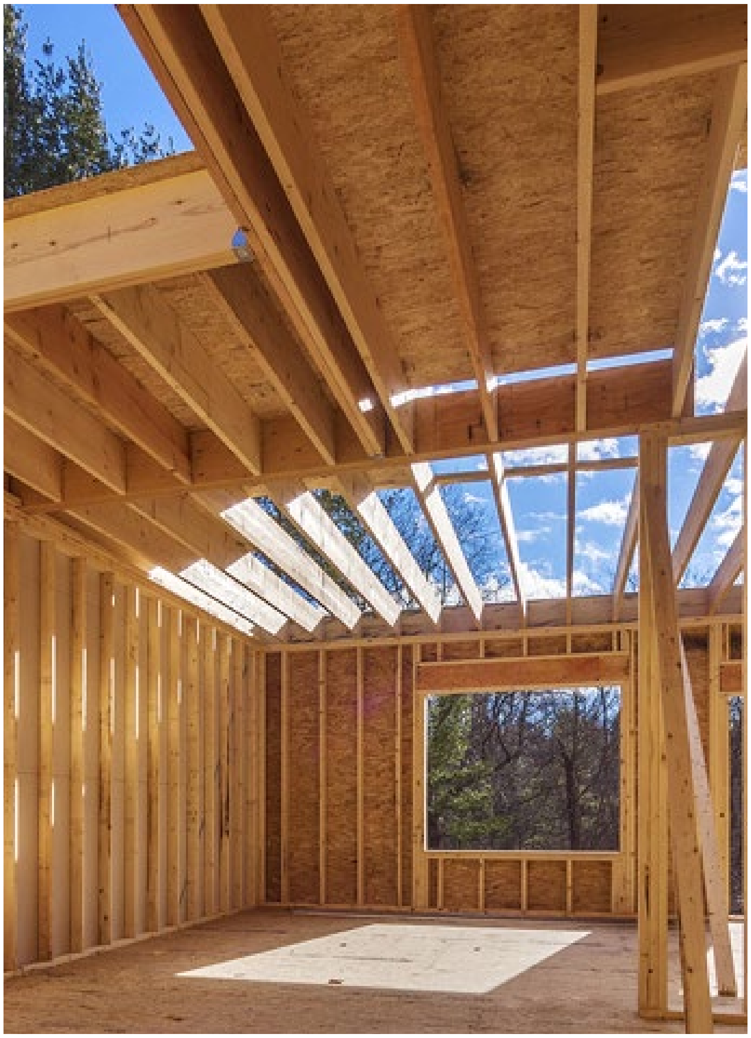
As buildable land grows scarcer and home prices continue to skyrocket, smaller homes have become more practical for builders and buyers alike. That's one reason the average U.S. home size fell to just over 2,600 feet in 2016. Surveys have shown today's buyers prize amenities over size and look for ingeniously designed homes with flexible spaces that can adapt to their lifestyle. Building smaller, amenity-rich homes can help builders shave material costs while maximizing constrained lot sizes.

Work efficiently

Running a lean operation boosts profit margins on every home you sell. Conducting a company-wide audit can help builders discover opportunities for improving efficiency. Leveraging digital tools to streamline and automate business processes, for example, could boost productivity by up to 60 percent and translate to $1.6 trillion in value for the construction industry—while also helping builders attract (and retain) tech-savvy young talent. Negotiating building supplies based on precise quantities can likewise trim waste from each home's cost.

Manage risks

In today's complex regulatory environment, risk management consumes a growing share of a home builder's budget. A self-administered builder structural warranty, for example, introduces significant uncertainty into a home's balance sheet. Without a third-party home builder warranty provider, builders risk paying out of pocket for costly callbacks and extended legal disputes.



A highly reputed structural home warranty company can mitigate these risks while ensuring warranty costs remain predictable. An insurance-backed new-home builders warranty can also be a valuable sales tool to help builders move inventory more quickly.

With construction costs escalating, it's getting harder to build affordable homes—but it can be done. Adverse conditions help fuel innovation, and the construction industry is no exception. As builders become leaner and more efficient, they'll be better poised to feed the surging demand for homes while tapping into the wealth of opportunity it represents.

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