BUILDING YOUR BUSINESS: MARKET STRATEGIES

Waiting for the Rebound

Savvy builders and developers should consider the effects of a new class of foreclosures

By Patrick S. Duffy

Historically, the market for new homes has generally bounced back faster than that of existing homes. However, the next rebound could be something totally different. While many builders have been cutting prices far faster and deeper than owners of individual resale homes, the rising tide of foreclosures—many of which are newer homes—could possible blunt the impact of these price cuts. Consequently, the sales recovery for new homes could not only be delayed, but be quite modest in comparison to past cycles.

To be sure, builders tend to act quickly when a market softens, and there's a good reason for that. According to Economist Christopher Thornberg of Beacon Economics, builders simply have more options because they're not emotionally invested in the homes they sell. "It's not that builders are smarter than homeowners," said Thornberg. "There is a rational reason why they're more flexible." And since builders can typically only retrieve their investments in land, labor and materials by selling homes, some cash is often better than none, if only to keep their operations open while awaiting a recovery.

In the early 1990s, when national new home prices in January of each year fell by two percent to four percent per year, prices for existing homes continued to rise by up to 5.6 percent as individual owners were slower to react to a changing market. But by instituting these pricing declines, builders made it up in volume, with new home sales rising by 20 percent in 1992 versus just 9.3 percent for existing homes. When new home sales slowed again in 1995, builders reacted with price cuts of nearly four percent, whereas existing home prices continued to rise by a very small but still positive 0.6 percent. By 1996, new home sales spiked up by 14 percent, or nearly double the 7.7 percent increase noted for existing homes.

Fast-forward to January of 2008, the situation is a bit different. In January of 2007 existing home prices fell by 3.5 percent from a year earlier versus a 4.5 percent rise for new homes. The result was a 26 percent annual decline in new home sales versus a 13 percent fall for existing homes. Additionally, when builders began cutting prices in earnest, the median sales price fell by 9.5 percent versus a 5.8 percent cut for existing units. Yet when comparing sales in January through April of 2008 versus the same period in 2007, new home sales tanked by 37 percent against a significant, but smaller, 19 percent decline for existing units.

> **"I'd expect prudent builders, lenders (and consultants) to incorporate analyses on local foreclosures into all of their feasibility studies and absorption assumptions."**

So what's the difference this time? Foreclosures. Whereas in the past homes being auctioned on the courthouse steps or offered by the REO departments of lenders were often old and in need of updating, many of today's foreclosures are newer homes that increasingly compete with unsold new home inventory. The trend is startling: with buyers enjoying rising home equity during the first half of this decade and low teaser rates offered on sub-prime and Option ARM loans from 2004 through 2007, mortgage delinquencies either fell or rose very slightly, generally less than two percent. But as these loans began to re-set and borrowers found themselves unable to finance due to negative equity, by the first quarter of 2008 delinquencies spiked up by 30 percent and the first stages of foreclosures skyrocketed by 71 percent on the heels of a 40 percent jump a year earlier.

It seems reasonable to assume that such record jumps in housing inventory – homes that will have to be discounted in price to sell – will impact both the timing and trajectory for a new home market recovery. "New home sales depend on the existing home market rebounding," Thornberg sais. "They may fall faster and stay in the pit longer while waiting for existing home markets to come back."

Patrick Duffy *is a Principal with MetroIntelligence Real Estate Advisors (www.metrointel.com) in Los Angeles and authors the Housing Chronicles blog (www.housingchronicles.com). He can be reached at* pduffy@metrointel.com

Fast Facts

- **Homebuilders are typically more rational and more flexible than existing homeowners in their sales.**
- **Historically, builders react to slowing home sales with price cuts much more rapidly than homeowners.**
- **Foreclosures in this market change the dynamic; builders need to adjust for this.**
- **Record jumps in housing inventory – homes that will have to be discounted in price to sell – will impact both the timing and trajectory for a new home market recovery.**