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## **Lots: Builders' Two Big Questions in 2017**

**As both cyclical and structural uncertainty prevail, the stakes grow more intense to get both the number and location of home sites right.**

**By John McManus**

Two difficult questions confront home builders and residential developers amid the uncertainty of the moment, and we've heard them in the aisles and off the floor during the home builders show in Orlando this year.

One is cyclical. The other structural. Both are material to what builders do this year, and what they do based on their plans beyond this year.

Good builders, we find, operate exceptionally well in two distinct but inter-related time spheres. One is in executing as flawlessly and with as much care and attention to detail as possible in the present. The other time referent embraces both lessons from the past and a willingness to work ferociously on yet-unrevealed challenge and opportunity in the future.

Of course, the reason for this comes from the very basic risk and reward of the business, both of which occur in the present and the future. Capital, time, and talent get front-loaded into an investment process, and the way those three precious currencies time-release value generation into the future--or destroy value--is where home builders live and die. The good actors pencil an internal rate of return on every piece of real estate they acquire, then set disciplines to expand margins beyond those hurdle rates. Getting back to the two hard questions, they're this. 1. Despite math that shows plenty of fundamental (pent-up) demand headroom and favorable ("still undervalued") conditions for home buyers, is a possible economic recession in the next two years not likely to draw the current upward trajectory of the housing cycle to a close?

Not saying it's going to happen. Am saying we're hearing builders talk about it, and the smart ones (maybe overly cautious?) are managing for it by trying to get more and more precise as to what they've got in their lot pipelines and how those lots need to perform in the near and longer term.

Now, it's characteristic for some builders to busy themselves checking for signs of a downturn long before it's really there, but this is the first year in many that we're picking up a sense from more than a few of them that the current recovery--modest though it's been in absolute gains from the trough of late last decade--may be "long in the tooth."

The second hard question taking discomfiting shape among builders is more structural. 2. What if, they ask, renting is the future for more households--i.e. a greater share--than in the past? Homeownership rates

have been falling. Everyone knows they're never ever going to approach the high-60s percentage they did in the early 2000s again.

The nagging question is "where is the settling point, all things being equal?" Closer to 60% or closer to 65%? Up to now, most of the focus of that question as far as we've heard pertained to young adult buyers. In other words, were Millennials going to define once and for all Renter Nation?

Now it seems, a slow-burn anxiety has started to crop up over the other demographic mega-cohort, Baby Boomers. Some builders are trying--nervously--to detect whether their 55+ buyers' attraction to turnkey living in more urban-style walkable communities with abundant culture and entertainment options might be siphoning off more of their buyer pool than they had thought.

Of course, it's builders' jobs to be nervous about this now, whether or not it turns out that their worries are validated by reality. They have an awful lot to gain from their boat-load of upfront investments if they're right about a buyer pool of demand stretching out ahead of them. And a disastrous amount to lose if they're wrong.

Fact is, the jury's not in. Both generational cohorts are massive--in the over 75-million people range--and, while demographics is all about big numbers, home building development, investment, and community-making is, on par, small numbers. Miniscule percentages of populations make or break business plans.

It's just interesting that, especially as single-family for-rent units and communities start to crop up, first as an asset class worthy of investment, and subsequently, as a viable business-model that can draw on new data technologies and operational scale, it makes sense that people on both ends of the age demographic spectrum would be excited to try it out. They're even more excited if the locations these available single-family rental communities offer are discretely more attractive for connection to natural, or cultural, or social, health-related, or entertainment amenities. Credit multifamily developers and single-family rental companies for meeting an unserved need, and executing at a high level of quality to have created 1.03 million new rental households between 2013 and 2015.

The big numbers of demographics allow for some fair share of folks to stream into those wider opening options vs. more traditional single-family detached 55+ communities without spelling the end of the world as we know it for 55+ for-sale.

What these flickers of pre-dominant trends show is that builders and residential for-sale community developers have their work cut out for them on the "small numbers" front of appealing--in location, price, product, and community.

The two difficult questions builders are asking themselves and each other bear directly on their appetite for lots right now. In more and more markets, builders are in a monetization mode--looking for inventory turns with increasingly disciplined operational and product programs to optimize margins--vs. balance sheet and asset expansion mode. The mergers and acquisition activity we're likely to see will give sellers opportunity to get maximum valuations for their assets with a solid inventory turn model, and a 18 to 36 month ramp-way to stay in and manage growth within a regional footprint before exiting. The deals will give buyers incremental volume with an opportunity to take out costs and flow transactions through a disciplined overhead structure, sourcing scale and efficiency, and marketing data and analytics clout.

While those two hard questions are working their way into builder sentiment, we see most of the focus on nearer-term horizons, margins, and pace, at least until there's clarity as to whether recession jitters are justified or not.



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