CAUTIOUS OPTIMISM PERMEATES MOOD AT MOSCONE

THE GENERAL SENTIMENT AT PCBC WAS CAUTIOUSLY OPTIMISTIC GIVEN THE LENGTH OF THIS CYCLE, BUT CONCERNS ARE OFFSET BY STRONG DEMAND FOR HOUSING, RISING WAGES AND LOW EMPLOYMENT, SUGGESTING THERE IS ROOM TO GO.

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By Lisa Brown

Wyman says capital markets are concerned that the resulting squeeze on margins will impact returns.

SAN FRANCISCO—For the past eight years, real estate law firm Cox, Castle & Nicholson has co-sponsored a roundtable during PCBC alongside Ernst & Young and The Concord Group. More than 50 executives from the building industry came together during this year's roundtable to discuss a wide range of topics related to the housing industry.

In this **exclusive**, Matthew Wyman and Erica Bose, partners on the firm's joint venture team, along with Cox Castle associate Christopher Stark, shared some insights from the conference in general.

GlobeSt.com: What was the general sentiment at PCBC this year?

Bose: We would describe it as cautiously optimistic given the length of this cycle, although perhaps less optimistic than last year. Developers voiced concerns about rising construction costs, particularly during the past six months, and the impact of rising interest rates and inflation generally. Land prices remain high as sellers have not fully internalized that developers are not willing to pay as much given these rising costs. That said, these concerns have been offset to a degree by strong demand for housing, rising wages and low employment, suggesting there is still room to go before we see an adjustment.

GlobeSt.com: What is the outlook for the rest of 2018 with respect to affordability, construction costs and labor availability?

Stark: Construction costs are expected to remain high for the remainder of 2018. While higher interest rates are putting pressure on home prices, rates remain relatively low from an historical perspective and the job market is still strong, so a price correction in 2018 appears unlikely. There is no clear fix for the labor shortage in the Western markets and this is unlikely to change for the balance of 2018. It is challenging to find skilled laborers, especially in light of the current administration's desire to drastically decrease immigration levels from Latin America. Moreover, the high cost of living in Western markets makes solving the labor shortage difficult. Laborers are priced out of the very markets where they are needed most.

What is the residential building industry seeing on the capital markets front?

Wyman: Generally, the capital markets have the same concerns that builders have in terms of where we are in the cycle and the impact of higher interest rates and production costs. They are concerned that the resulting squeeze on margins will impact their returns. As a result, investors will likely continue to scrutinize builder proformas and remain deeply skeptical of revenue increase assumptions and any failure by the builder to include cost increase assumptions. That said, there is still plenty of capital chasing deals and a willingness to invest earlier on in the development cycle in light of the shortage of finished lots. As one capital provider put it, he is happy to invest in a project projecting a 20% internal rate of return with realistic assumptions, figuring that even if the project ultimately misses on its projections a bit, it will still probably achieve mid-teen returns, which is perfectly acceptable.

GlobeSt.com: How are the tax law changes affecting the way the industry is conducting business?

Bose: The impact of the changes to the federal tax code is a nuanced question, but builders generally did not report substantial changes to their business plans in light of these changes. Land developers expressed frustration with the extension of the holding period for capital assets from one year to three years in order to claim carried interest as long-term capital gains (as opposed to ordinary income). Homebuilders noted that other asset classes, such as income properties, have benefited from changes to expanded depreciation allowances. To date, the changes to the tax code do not seem to be having a meaningful impact on the homebuyer appetite.

GlobeSt.com: What is next for the homebuilding space?

Stark: The impact of the Millennial purchaser continues to change the homebuilding landscape. These consumers demand high-quality Internet access and cellular service, so buildings must be pre-wired to address these demands. In addition, traditional multifamily developers have started to incorporate collaborative workspaces (think WeWork) into projects as an additional amenity. Pre-manufactured housing was discussed in a good amount of detail, specifically with respect to the abundance of this type of construction in Japan, where it has been very cost effective and has an environmentally low impact given the focus on re-use and recycling of byproduct. Some are skeptical of this becoming a meaningful component of building in the United States, especially while there continues to be a preconception that prefab homes are of inferior quality, while others think it is the wave of the future.

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Lisa Brown is an editor for the south and west regions of GlobeSt.com. She has 25-plus years of real estate experience, with a regional PR role at Grubb & Ellis and a national communications position at MMI. Brown also spent 10 years as executive director at NAIOP San Francisco Bay Area chapter, where she led the organization to achieving its first national award honors and recognition on Capitol Hill. She has written extensively

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