

## **STILL ROOM FOR GROWTH IN HOUSING MARKET**

### **INDUSTRY PERSPECTIVES FROM PCBC 2018**

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By Erica A. Bose, Mathew A. Wyman and Christopher D. Stark



*Erica Bose, Partner at Cox, Castle & Nicholson LLP*

Developers, capital providers and other industry professionals attended the Pacific Coast Builders Conference (PCBC) in San Francisco over the last week of June 2018 to exchange ideas, discuss market trends and share their outlook on the direction of the homebuilding industry. This year, the general sentiment of developers could be described as cautiously optimistic given the length of this cycle, but perhaps less optimistic than last year. Homebuilders voiced concerns over rising construction costs, particularly over 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.

Developers are also struggling to find skilled laborers to build their product. Developers reported that there is no clear fix for the labor shortage in Western

markets, and this is unlikely to change for the balance of 2018, especially in light of the current administration's desire to substantially decrease immigration rates from Latin America. Moreover, the high cost of living in Western markets makes solving the labor shortage particularly difficult. Laborers are priced out of the very markets where they are needed most.



*Christopher Stark, Associate at Cox, Castle & Nicholson LLP*

While the industry continues to digest the impact of cost and rate increases to their business plans, homebuilders did not report making significant changes to their business plans in light of the changes to the federal tax code. Of course, evaluating the impact of tax code changes is nuanced and driven, in part, by individual circumstances, so it is somewhat challenging to neatly summarize it. That said, 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. In any event, the changes to the tax code do not seem to be having a meaningful impact on the appetite of the retail homebuyer.

The capital markets expressed the same concerns that builders have with respect to where the industry is at in the real estate cycle and the impact of higher interest rates and production costs. They are concerned that the resulting squeeze on margins will negatively impact their returns. As a result, investors will continue to closely scrutinize builder proformas and remain deeply

skeptical of revenue increase assumptions and any failure by builders 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



*Mathew Wyman, Partner at Cox, Castle & Nicholson LLP*

shortage of finished lots. As one capital provider put it, they are willing to invest in a development projecting a twenty percent internal rate of return with realistic assumptions figuring that, even if the project ultimately misses on its projections, it will still likely achieve acceptable returns in the mid-teens.

Developers also opined on what is next for the homebuilding space. As developers grapple with rising costs, they are evaluating alternative construction processes. Pre-manufactured housing is one such option and already enjoys widespread use in Japan, where it has been very cost effective and has an environmentally low impact given the focus on reuse and recycling of byproduct during the manufacturing process. Some in the industry are skeptical of pre-manufactured housing becoming a meaningful component of building in the United States, especially while there continues to be a preconception held by retail purchasers that pre-manufactured homes are of inferior quality. Still others in the industry firmly believe it is the wave of the future, as developers continue to make investments in strategic technologies.

The impact of the millennial purchaser also 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.

They are also interested in collaborative/shared workspaces offered as an amenity in multi-family projects and are less focused on the actual square footage of their individual units. Residential purchasers are focused on lifestyle, and developers are listening by looking to offer urban amenities (such as retail) in suburban communities. The industry is keenly interested in how these trends will play out and expects that they will continue to be key topics of discussion at PCBC 2019.

Erica A. Bose is a partner at Cox, Castle & Nicholson LLP, a full-service law firm focused on real estate. Based at the firm's Los Angeles office, she can be reached at ebose /at/ coxcastle.com or (310) 284-2200.

Mathew A. Wyman is partner at Cox, Castle & Nicholson LLP. Based in the firm's San Francisco office, he can be reached at mwyman /at/ coxcastle.com or (415) 262-5100.

Christopher D. Stark is an associate at Cox, Castle & Nicholson LLP. Based in the firm's Los Angeles office, he can be reached at cstark /at/ coxcastle.com or (310) 284-2200