

Industry Forecast Offers a Mixed Bag

Houston construction likely in a holding pattern for 2010



With the room filled to capacity, Metrostudy's Mike Inselmann shared building industry trends and outlook for 2010. More than 900 guests attended the GHBA Forecast Luncheon held at the Westin Galleria on January 11. Members of the audience also included more than 50 elected officials. The following are highlights from Inselmann's presentation.

National Economy

Jobs: While the national economy is showing signs of beginning the long road back to recovery, recapturing the jobs lost in the past 18 months is proving to be a more difficult challenge. The December jobs report represented a setback for those who believed the months of negative employment reports were behind us. The U.S. shed an additional 85,000 jobs in December.

Losses continued in construction, manufacturing and wholesale trade, while temporary help services and health care continued to add jobs.

During 2009, monthly job losses moderated substantially. Employment losses in the first quarter of 2009 averaged 691,000 per month, compared with an average loss of 69,000 per month in the fourth quarter.

Unemployment: National unemployment remained high and unchanged in December at 10%. Clearly, U.S. companies are still shy about ramping up their employment rolls until they are more confident in the certainty of a recovery and there is more clarity about the confusing array of new legislation working its way through Congress.

Business owners see that activity and worry about higher costs of energy (cap and trade), additional taxes and higher

costs of employee benefits (health care legislation) and remain reluctant to beef up payrolls until they are sure of the additional costs they will incur with each new hire.

Banks: The banking industry, with emergency help from the Treasury, appears to have survived the worst of the banking crisis, losing some major long-term players along the way. But the survivors remain fragile, with balance sheets bloated with assets of dubious value, and serious scrutiny and oversight from federal regulators. Investment banks are dealing with toxic assets, and depository banks are awash with real estate loans of uncertain quality. While credit markets have improved and some liquidity is better than none, credit remains very hard to secure for many borrowers, especially real estate and development companies. Community and regional banks across the country remain threatened by the burden of real estate portfolios and actions of bank examiners and regulatory authorities.

Consumer Confidence: Consumers remain cautious, despite the relatively upbeat reports about Christmas retail sales. In most measures, the 2009 holiday sales reports are good only in comparison to the abysmal 2008 reports in the midst of the financial meltdown storm a year ago. It takes extraordinary efforts (e.g. Cash for Clunkers) to stimulate big-ticket buyers to action. Even with some improvement, the Consumer Confidence Index remains at levels more indicative of recessionary spending patterns.

Housing: In 2009, an estimated modern historical low of 440,000 single-family new-home starts were recorded. The National Association of Home Builders (NAHB) is projecting a 25% increase in single-family starts, to just over 600,000.

Although this would be an improvement, it is nothing close to relatively long-term normal demographic demand level of 1.5 million starts per year. Near-term limiting factors are the overhang of existing homes and foreclosure inventory and the depressed levels of existing-home prices in some of the very hard-hit regions of the country, namely California, Arizona, Nevada and Florida.

In recent months, the Case-Shiller home price index increased for five consecutive months (July through October), and although home prices could continue to drop a bit in some markets, most of the price decline has probably already occurred. If so, the delayed housing market recovery could well be upon us, assisted by very favorable affordability (due to low prices and interest rates and the extension and expansion of the first-time buyer tax credit that is credited with increased sales volume in the second half of 2009).

But, housing demand cannot achieve a solid recovery without an improved economy and real job growth. The job market is still weak, and only buyers with real down payments and stellar credit scores can secure mortgage loan approvals.

On the other hand, builders cannot increase the pace of new construction without an expansion of acquisition, development and construction financing (which actually would mean a reversal of the current tightening trend that is occurring).

Nationally the foreclosure activity will remain a drag on the hardest-hit markets of California, Arizona, Nevada, Florida and Michigan. The weak job market will likely throw more homeowners into the foreclosure morass in those states, which, with the exception of Michigan, were among the most active housing states in the nation.

Homebuilder inventories are no longer a drag on the market. Builders have spent the past two years grappling with reduction of unsold homes, developed lot inventory, and land owned for future development. By lowering prices, negotiating with lenders and seeking outside capital, builders have mostly gotten their finances in order.

While privately owned builders are still facing reduction in credit availability

to participate in the early stages of any housing recovery that is at hand, public builders are mostly looking at 2010 as a time to capitalize on weak competition, lower costs of construction, and the stimulative effect of the homebuyer tax credit to seize market share and kick start their participation in what they expect to be a long, slow new-housing recovery.

Public builders across the country are eyeing the acquisition of discounted lots available from lenders and investors as the key to dominating the demand for new housing in many states nationwide.

During the first 12 months of the slow recovery, improvement will likely appear uneven. Foreclosures now in process will be distressed sales, and there will be increased numbers of new foreclosures emerging from Alt-A and option ARM resets. This will contribute to the jaggedness. Slowing the early part of the recovery cycle will be the high unemployment rates and the likely tightening of some FHA loan standards (higher minimum credit scores and larger down payments).

With various economic trends bottoming out in mid-2009, and those same trends improving in an uneven manner, the four-year downturn has apparently come to an end for homebuilders in the U.S. But it is a sloppy and uncertain bottom they have reached, and the slope upward will be slippery and uneven.

Houston Outlook

Because Houston was protected for many months by high and rising energy prices in 2008, it was among the last major MSAs to be pulled into the current recession. Finally, when energy prices fell in the second half of 2008, job growth slowed and turned negative at the beginning of 2009. It is estimated the Houston area lost roughly 90,000 jobs last year. Construction, manufacturing and international trade all lost between 16,000 and 23,000 jobs. Eventually, natural resources and mining — which, in Houston, is largely oil and gas, turned negative. The losses in oil and gas mainly consist of high-income workers, and those job losses will likely impact businesses that depend on discretionary consumer spending.

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Photo top: A highlight of the luncheon was the installation of the new GHBA president, Kevin Holland, Cervelle Homes. He was sworn in by installing officer Larry Taylor, Texas State Representative.

Photo bottom: Outgoing president Lisa Clark, Ryko Development proudly receives her past president's pin.

Housing demand can be temporarily shored up with tax credits and low interest rates. But for housing demand to be sustained, it must have fundamental support in the form of job growth, which provides qualified buyers and stimulates new household formation.

The domestic count of active drilling rigs has risen 32% from the low in this cycle but remains 40% below the peak a little over a year ago. More companies are focusing on oil drilling instead of natural gas. There is a larger-than-normal gap in price between oil and natural gas, so many drillers see better returns coming from oil production for the near future. Longer term, oil is a comparatively scarcer commodity than gas, whose price is currently depressed, and the industry is sitting on a very large inventory of stored supply.

Houston Housing: Constrained credit availability is an overarching factor that will affect the way housing of all kinds performs this year and the foreseeable future.

Apartment construction in Greater Houston will be the slowest seen in perhaps a decade, due to the inability to finance new projects by conventional methods. Only government-backed HUD financing will be viable for new apartment construction for the foreseeable future. This slowdown in new supply will allow local property owners to work off excess inventory of vacant units and rebalance supply and demand heading into 2011, likely leading to rising rents next year.

Condominium construction has come to a screeching halt. The poor sales performance of most of the new proposed projects kept many of them from ever getting past the pre-sale stage or beginning construction. Most of those that did get built ran headlong into limited demand that began slowing in 2007, along with the rest of the housing industry. It will likely be several years before financing will be available for a new condominium project in the local market, especially for expensive luxury condominiums.

New single-family homebuilding continues to experience a "sloppy bottom" of the cycle. While it certainly appears the bottom is behind us, builders continue to lean against headwinds in an effort to kick start the up-cycle.

Since the peak of 51,000 homes built in 2006 to the current pace of just over 18,000, home construction in Houston has fallen 63%, and it is hard to believe that only Austin, Texas, with a drop of 61.4%, has experienced a slightly smaller percentage drop.

In order to begin a meaningful recovery in home sales and starts, the industry will have to overcome a variety of issues:

- **Fear:** Consumers continue to be unsure about the wisdom of homeownership, and they have remained very conservative financially—spending less and saving more.
- **Mortgage Credit:** It continues to be difficult to qualify for a mortgage. Down payments are required and applicants must have pristine credit ratings.
- **Construction Financing:** It is very, very, very difficult for a privately owned builder to secure construction financing from traditional banking sources. Overloaded real estate bank portfolios have essentially taken most of the bigger players out of the market, especially for new customers. Banks are even working to reduce their loan commitments for existing relationships, meaning most private builders are unable to build as many homes as last year because there is less money available to them.
- **Existing-Home Inventory:** Buyers have a lot to choose from in this down market, especially early in the year. Later in the year, we expect the supply of homes to become scarcer due to lack of new homebuilder supply.
- **Home Prices:** Builders find they must offer a good value when compared to existing homes on the market, and many times find themselves competing with their own floor plans that are less than three years old.
- **Weak Job Growth:** Houston is projected to continue to lose jobs through mid-year before growing in the second half. So, during the spring selling season, few jobs will be created, and Houston will end the year with less than 15,000 jobs added for the year, a weak performance for a rebound year.

On the other hand, there are some reasons to be optimistic. Two reasons are the extension of the home-buyer

tax credit and housing affordability (low interest rates and low home prices).

And, public builders exhibit the most optimism as 2010 begins. Public builders are beginning the year very aggressively. They don't depend on local banks for financing, so they have the capital to expand their business. Several are aggressively putting speculative inventory into the market and betting on the first half of the year because the first-time home-buyer tax credit has been expanded and extended through May. Builders saw a positive effect on home buyers last year from the tax credit. Also, most industry observers expect the current low mortgage interest rates to rise later in the year because the Federal Reserve has stated its intent to cease buying mortgages in April.

So, it is likely there will be an increase in activity in the first half of 2010, as big builders test the market to see if it will support their strategy. If not, those public builders will have the balance of the year to adjust their production and work off

the inventory built early in the year. A part of their strategy is to seize market share from builders who cannot secure financing or are struggling with financial problems or are still burdened by assets they cannot dispose of such as unsold homes, subdivision lots or vacant land.

Land Development: There currently is virtually no new land development activity to build new lots for home construction. The local market has an ample supply of lots on the ground for production this year. In some cases the most active communities will construct new lots for ongoing homebuilding programs, but getting financing for new sections of lots is not assured. In fact, it ranges from difficult to impossible to secure development financing for lot production today in Houston or anywhere else in the U.S.

Even with all the issues, the net result is that Houston likely passed the low point in the cycle in the early months of 2009. Builders started roughly 18,000 homes

in 2009, and will close 21,000 sales and reduce inventory once again by 3,000 homes. Builder inventory of homes under construction has dropped from 18,000 to below 6,000 since mid-2006. Most builders are entering this year with leaner operations, less inventory and lower costs for construction.

The tax credit has stimulated additional buying in the past six months, and now that it has been extended, builders will enjoy a push from that tool and some of the lowest interest rates in history.

"2010 will not be a rebound year," concludes Inselmann.

"Metrostudy expects the industry to build and sell between 18,000 and 20,000 homes this year, essentially another year of bottoming out," he adds. "2010 will be a holding-pattern year, while factors outside of the homebuilding industry continue to improve—economy, jobs and financial markets. Once that is done, the housing industry will enter a period of sustained volume growth for several years." ■



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