Evolve or Perish – What's a small builder to do?

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I'm here to give you the bad news – something that many of you will not want to hear.

The world is changing, and the majority of you are on the wrong side of the curve. Like the dinosaurs who roamed the earth when the asteroid struck, you can either adapt to the new situation, or the majority of you can eventually become extinct. Some of you are good enough and smart enough that you may delay that inevitable demise for many years. Others, because of what you build or the markets in which you operate, will only be affected to a lesser degree. But make no mistake, the realities of life for the custom homebuilder in the United States will never be the same again.

The current housing downturn is different from previous downturns. What we are facing is not simply a temporary shift in market demand that will be set right once confidence returns. What builders confront today is a paradigm shift, a rule changing event that is poised to shatter the status quo and rewrite the rules on how to succeed in the new order.

What is a paradigm shift?
Every once in a while, the way we perceive the world suddenly changes, with wide ranging impact on every aspect of existence. When Copernicus and Galileo insisted that the earth revolved around the sun, and not the other way around, it had profound implications for navigation and theology, as well as science. When the World Wide Web brought the Internet into every home, all the old paradigms about information distribution were shattered. Now the information you wanted was available anytime, anywhere, and practically for free. It removed the middleman from many transactions, bringing buyer and seller closer (disintermediation).

The interesting thing about paradigm shifts is that they take place over time, and are often not even recognized at the time. To speed acceptance, they often cloak themselves in the trappings of the old perceptions. The railroad was called "the iron horse," and the automobile "the horseless carriage." For a while, the old paradigm and the new co-exist side by side, until the new eventually replaces the old way of doing things. "Dead tree" newspapers and magazines continue to publish alongside the new media of the e-zine and blogosphere, though with reduced influence and economic viability. Google advertising is more effective than print advertising since it can be delivered within a context – based on what the viewer is researching.

The last major paradigm shift in the housing industry was the advent of production builders following World War II. The best known practitioner of this shift was William Levitt, who used the principles of mass production to reduce the cost and speed the construction time of residential housing. His insight was that the construction site was actually an outdoor assembly line, and instead of moving the car along, he simply moved the labor from house to house. He standardized the offerings (originally offering two homes, and eventually up to seven), with limited customization. His original homes were 750 square foot Cape Cods, with 2 bedrooms, 1 bath, a kitchen and a living room. The second floor was unfinished and there were no garages.

The home sold for $7,990, on 1/7 acre of land, and were so efficient to build that the price included $1,000 in profits. Today those homes in Levittown sell for more than $200,000. Later models increased to 1,500 square feet, and offered two full stories and a garage. Before Levitt came along, the average builder in the U.S. built four homes a year. Levitt built as many as 17,000 in a single development, and built out the entire project in six years. Imagine declaring an open house and having 30,000 people show up, or closing 40 to 50 houses every week. That was the achievement of William Levitt.

Why this housing downturn represents a paradigm shift

In most economic downturns, declining economic conditions (decreasing GDP, increasing unemployment) temporarily impact the ability of homebuyers to purchase a new home, and sales decline. Eventually conditions improve and the market returns to normal. In this instance, however, the market downturn wasn't driven by events outside the housing industry – in fact events within the industry drove the outside market itself. The primary driver was speculation and greed. The rising housing prices and increased speculation drove housing prices at an unsustainable rate, leading to a housing bubble. To fuel that bubble, the financial industry created a whole series of innovative ways to finance new homes, including sub prime lending, interest only loans, and lowered qualification standards. To allow banks to lend beyond their own capital resources, they invented a slew of new financial instruments, turning mortgages into securities which could be sold on the open market, like stocks, but with little regulatory oversight.

Because of these interlocking aspects of the housing sector, a decline in housing sales led to a host of related failures. First, the declining sales and excess inventory in overbuilt markets led to pricing declines. The price declines brought into question the value of the mortgages issued, especially the sub prime loans with little equity involved. This led to a spate of foreclosures which further depressed the market, and threatened the survival of those banks and institutions now holding the depressed financial instruments.

The paradigm shift is the realization that the myths of the free market espoused by our government for so many years may no longer be true. The invisible hand of the free market may not always guarantee the best outcome, especially when manipulated by greed driven operatives whose only loyalty was their immediate profit. Conspicuous consumption, driven by higher levels of consumer debt, may not be the best engine of growth and prosperity, but instead needs to be replaced by responsible investment, oriented toward the future rather than immediate return.

These shifts will have a profound impact on the housing industry itself. Since a home is such a large investment, and few people have the money required to buy a home sitting in their bank accounts, housing is highly dependent on fluctuations in credit availability and interest rates. A shift to a long term investment strategy for housing will mean housing price increases will be tied more closely to gains in wages and earnings, rather than speculative interest. In addition, there will be more interest in the total lifetime cost of the home, including energy costs and maintenance. Value will replace status as the prime motivator in new home purchase. And those builders who understand these shifts and can adapt their operations to take advantage of them will survive. Those who cannot will gradually fail.

These changes will be reflected in many areas, including economic, competition, speculation, and regulation.

The Affordability Crisis

At the heart of this paradigm shift lies a basic corrosion of housing affordability within the country. While the economy continues to grow slowly, wages for the middle class have been stagnant over the past ten years. At the same time, housing prices rose at an unprecedented rate (in some markets by 10 and 20% per year), resulting in an affordability squeeze. The cost of construction has increased as well, due to higher materials cost, labor shortages, and increased regulation. Less affluent buyers were simply priced out of the market, or they accepted sub prime mortgages that have exploded with rising interest rates.

Since many of you build higher-end homes, you may feel that this doesn't really affect you. After all, your buyers are doing quite well. But the problem is that the housing market is a series of inter-related markets, each depending on the other for financial success. I call this the housing escalator. A young couple buys an entry level home, and then in a number of years, as the family expands and their success increases, they look for another home, bigger and more expensive. But in order to buy a new home they have to sell their existing home. If there are no buyers, they are stuck where they are. This is why a crisis of affordability affects even buyers of upper scale housing.

The basic issue of housing affordability is an inescapable fact of life. If housing prices have risen beyond the consumers' means, and there is no expectation of a continuing price escalation, then we have entered a period of stagnant sales, without the lure/fear or rising prices to drive them. In other words, rising prices drive people out of the market by reducing their ability to buy, and the *lack* of rising prices deprives them of an incentive to purchase anyway. It's a lose/lose situation either way.

The only escape from this pricing escalation trap is for the housing bubble to burst, and housing prices to return to sustainable levels. However, there is a deep-seated resistance to this solution on many fronts. First, owners of existing homes are reluctant to reduce the sales price of their homes, because this would force them to confront and acknowledge the loss of value. Until they actually reduce the price, they can pretend that things are just fine, and that prices are stable.

This is what happened in Japan after the Asian market meltdown in 1987. The Japanese banks' refusal to admit their losses led to a ten year stagnation of the market rather than a quick recovery. This reluctance of existing owners to lower prices to realistic levels could provide an advantage for new home builders that have lowered prices to new market levels. However, the overhang of foreclosed properties makes it difficult for all sellers in this market to make any headway.

Another source of resistance comes from the industry itself. Rising prices for land, labor, and materials has driven the hard costs of construction even higher, and in many cases beyond, sustainable price levels. When home buyers were willing to spend $200 or more per square foot of home, it was easy to get complacent about controlling costs. But if the sustainable hard cost is closer to $100 per square foot or less, builders have to find innovative ways to cut hard costs. And if you think that means returning to shoddy workmanship, boxy boring homes, and cheap materials, think again. The American consumer is spoiled – and they won't accept those ticky tack houses of the 50's whose only virtue was their affordable price. They will stay where they are and refuse to buy, rather than accept less. They will accept smaller houses, smaller lots, and mid-range amenities, but they will refuse to go below their threshold of quality living.

The two economies

The American economy is divided into two segments, the real economy and the financial economy. The real economy is that of production – manufacturing, services, farming, homebuilding, etc. The financial community is based on money manipulation – banking, investing, the stock market, hedge funds, etc. When these two economies are in balance, they play off and support one another. The real economy relies on the capital infusions of the financial economy, and the financial economy uses the gains of the real economy as the basis for its operations. Without General Motors there would be no General Motors stock, but without the investment, there would be no General Motors.

The problems arise when the financial economy seems to run ahead of its grounding in the real economy – and takes on a life of its own. This divorcing of the financial world from reality is what leads to bubbles – the high tech bubble of the late 90's, and the housing bubble of the early 2000's. Bubbles inevitably lead to collapse.

In both senses of the word – psychologically as well as criminally – the financial market is a confidence game. Unrealistic levels of financial activity can be maintained only as long as the public is firmly convinced that these levels can be maintained or increased. But basing economic performance on the fragile underpinnings of human psychology is a risky endeavor at best, and will inevitably lead to both bubbles and their collapse.

Speculation

When the stock market tanked in 2001, investors looked around for a better place to put their money. As they viewed the rising housing prices (fueled by low interest rates), they decided "this is the place for me." Many jumped into the market in places like Nevada and Florida, intending to "flip" their investment in a short time, and driving up prices even higher.

In responding to this increase in demand, builders increased production. But the speculation required that prices continue to rise at an astronomical rate. When this proved unsustainable, the speculators quickly jumped out of the market, leaving the builders with a huge unsold inventory. This unsold inventory continues to hang over the market, suppressing sales and prices.

The problem with speculation isn't that it increases or decreases demand – it's the volatility of that change. Builders want a slow steady demand curve, that they can plan for and respond to, without the roller coaster of artificially inflated expectations that collapse on the slightest negative event, turning a minor problem into a major catastrophe.

Demographics and Demand

Paradoxically, despite plummeting new home sales, there is an incredible pent-up demand for housing in the U.S. What is driving this pent-up demand is new household formation – young people marrying and starting a family, or moving out from family to start an independent career. Divorces also create new households, as does immigration.

The problem is that the pent-up demand is created at the lower end of the income spectrum, and is for quality *affordable* housing – housing that median and moderate income families can afford to buy without breaking their budget. Unfortunately, increasing costs of production, the housing price bubble, and restrictive regulation have reduced the supply of such housing, and in some areas such housing has ceased to exist.

Notice that I said *quality* affordable housing – which some view as an oxymoron in and of itself. In every market you can find low-cost, run down, dilapidated housing, or housing in poor neighborhoods. But few want to live in such housing, and in fact, such housing should be torn down and rebuilt. Builders have become good at supplying the upper end of the market – people with higher incomes and existing equity, but have increasingly fallen behind in supplying the lower market.

Regulation

Another factor that has driven the cost of housing skyward is the increasing tendency of cities and towns to impose restrictive zoning and growth policies on the housing industry. Part of this is a reaction to the unintended consequences of unfettered building practices of the 50' 60's and 70's – with sprawling suburban growth leading to congested streets, ugly, anonymous housing tracts, and higher public expenditures for roads, schools, and infrastructure. We knew we needed more housing, and the public preferred the single family home to high density projects, but we hadn't figured out how to create viable, livable, and sustainable communities while fulfilling that American dream.

In reaction to that growing dissatisfaction, several planning and design professionals tried to implement a new housing model – the New Traditional Development (NTD) that combined the higher density and greater community amenities of older neighborhoods, with mixed use (residential, employment, and commercial side by side), and a greater emphasis on quality architectural design. As with any new idea, the acceptance and implementation takes time, but is slowly gaining ground. Until that happens, local political resistance will continue to escalate the cost of development, through a slower approval process, impact fees, and restrictive covenants. The NIMBY (Not In My Back Yard) and no growth, slow growth, or "smart" growth movements will continue to act as a brake on new home construction.

Competition

If you wonder why builders have concentrated on the upper end of the market when the buyers were concentrated on the lower end, you simply have to follow the sage advice of famous bank robber Willie Sutton. When asked why he robbed banks, he replied, "Because that's where the money is."

Those areas of the country that have been hardest hit in the housing meltdown were those "hot" markets with lots of builders competing for an increasing number of buyers. All that competition drove up production and inventory, and the high overhead of the larger national and regional builders insured that those inventory levels remained high, even when signs of the market softening became apparent. Those areas that fared best were the smaller markets, with fewer and smaller builders – who tried to tie their production directly to demand.

While competition is supposed to increase efficiency and lower costs to the consumer, in this case it had the opposite effect. When competition becomes too fierce, fueled by speculation, it tends to reinforce the bubble, driving up material, labor and land costs, and overproducing for unrealistic demand.

As the affordable segments of the housing market became uneconomical, production builders decided to move upscale, crowding into an already crowded market. These production oriented builders have adopted some of the benefits of the custom market (they are willing to customize a stock plan), and they offer a lot of value for the dollar. As the lower and middle segments of the market get crowded out, these production builders will continue to invade the custom segments, driving out the weaker, less sophisticated custom builders.

The conventional wisdom of American enterprise is that bigger is better. Larger companies have more access to investment capital, are better able to borrow large sums of money, enjoy economies of scale in production and purchasing, and have the financial and personnel resources to gain an advantage in the marketplace. But all those advantages are predicated on the workings of a normal, rational market place. In this upside down economy of ours, all those advantages can become disadvantages – as sources of capital and investment dry up (as markets become illiquid), and as the huge upfront investments in land and unsold inventory become a drain on the bottom line. In that case, smaller and more nimble is better – better able to respond to changes in the marketplace – better able to tailor inventory to demand, and avoid the traps that the larger builders inertia carried them into.

Capital Requirements

In discussing competition, we discussed the larger builders' ability to borrow as a competitive advantage. But in this topsy-turvy market, as banks freeze lending and even highly qualified home buyers have difficulty obtaining a mortgage, that advantage is negated, and can even be a liability if the builder carries an existing high ratio of debt.

Paradoxically, despite the destruction of paper wealth in the stock market, and the decline in housing values, there is still an incredible amount of money floating through the financial system. But with the financial uncertainty, few are willing to lend it to others – afraid that those they lend it to might fail, and afraid they may need their cash reserves to protect their own financial viability. Just as occurred after the stock crash of 2001, investment tends to move out of Wall Street, and begins looking for safer, more productive places to invest. It is unlikely that much of that will be transferred to housing – at least until the housing market recovers, but the money is still out there. This is why any plan that renegotiates mortgages that are currently underwater or in danger of foreclosure would be a positive step in staunching the flow of red ink and improve the overall basis of the economy.

What is likely is that interest rates will be lowered in an attempt increase the flow of credit, and reduce the cost of capital. However, until housing prices stabilize, lowering interest rates will be an insufficient motivator to increase housing sales.

Who's at greatest risk?

Just as all areas of the country aren't equally impacted by the downturn, all segments of the housing industry will not face the same level of challenge. Some builders, especially those in highly volatile overbuilt speculative markets are already suffering major market dislocations. But all builders will have to face the crisis in consumer confidence in one way or another.

In addition, the ability of a builder to weather this story is a function of the individual builder's financial situation, and managerial acumen. Obviously, this is a good time to be sitting on a pile of cash – and not a good time to be heavily in debt, or with a large inventory of lots or spec homes. Operations with a smaller overhead, low payrolls, and good credit will fare better than those who relied on a constant velocity of sales to maintain momentum.

So what's the smaller/custom builder to do?

Listening to the news recently, you would think that all is gloom and doom for the housing industry. Yes, there are significant problems to be overcome, and the "soft landing" hoped for earlier in the crisis isn't going to happen – at least not anytime soon. Market conditions will continue to languish as long as the liquidity crisis continues, and as long as housing prices remain unstable. We can't predict how long it will take to move through this crisis because it all depends on what the government and industry as a whole do in reaction to the situation. But there is a silver lining in all this negativity. And that is, if the financial system is overhauled, and housing prices stabilized, the industry could return to a much stronger basis for growth – driven by a strong underlying demographic demand, rather than the speculative fevers that ultimately lead to collapse. If prices can again be linked to income growth – so that the median buyer can afford the median home using the sustainable income rations of the past, there could be a long and productive golden age of housing in the United States. And if we learn to build communities that bring us together and are integrated into the larger community fabric, the quality of life and the social cohesion of the nation will also increase.

We have identified two separate strategies that smaller builders can follow to reinvent themselves for this new market opportunity. They can be pursued independently or together – the only distinction is that you have to do *something*. Continuing on your present strategy in the face of a paradigm shift is a recipe for ultimate failure.

Macro Strategy: Be able to think and act bigger

As we explained in the section on competition, in normal times larger builders have a built-in advantage due to their greater capitalization, access to expertise, and economies of scale. What the smaller builder needs to do is to find ways to enjoy those same advantages, without the disadvantage of higher overhead or capital investment. Here are some of the ways builders can enjoy those advantages.

- **Builder alliance – local or regional.** In some markets, builders have banded together to work cooperatively for a common good. For example, they may pool their resources to develop a community together, with each contributing to the cost, and each sharing in the sales benefits. By careful coordination, they can avoid destructive head-to-head competition – with products that supplement each other, and enlarge the market pie, rather than fighting over the smaller pieces. These alliances can also cooperate in other ways – sharing personnel resources, and marketing efforts. They can create a critical mass of awareness, rather than being lost in the marketing clutter. And they can act as a de-facto standard of quality – reinforcing each other's brand identities.
- **Buying groups.** These locally based affiliations can negotiate with lumber dealers and building supply houses to lower costs across the board for their members. Some of these have been so successful on a local level that they have expanded their model geographically across the United States.
- **Joint ventures.** When banks tighten their lending, they often require greater equity on the part of the builder or developer. If you are sitting on a pile of cash – no problem. If not, you may have to find outside investors or capital partners to provide some of the equity you need. Typically these are wealthy individuals or firms specializing in equity investment, and they expect a much higher rate of return than your local bank. But it does spread your risk somewhat, and enables you to attempt projects that would otherwise be beyond your reach.
- **Franchise systems.** The ultimate extension of the outsourcing principle is to align your company with those companies that provide total turn-key services, in exchange for a share of the revenue. Typically they provide assistance in product design, marketing, back office management, and quality control. They provide the systems you need to run your entire operation as long as you follow their operational procedures. The danger with this strategy is that you can lose sight of what brought you to the housing market in the first place – a drive to express your own personality and control your own destiny. As long as you are comfortable within the parameters provided, this is an excellent way to gain state-of-the-market management systems, and concentrate on those areas of your company where you can have the greatest impact.

Micro Strategy: Change yourself

Whether or not you can pursue a macro strategy of becoming part of a larger solution, you will need to transform your own company to reflect the changing market conditions. As with all true change – it begins with you – with your own mindset. Simply recognizing that the rules are changing – perhaps for the better – enables you to proactively position yourself to take advantage of those changes.

- **Change your mindset.** The primary shift in consumer perspective that builders will have to adjust to is a shift from a status driven speculative investment bias to a value-driven better livability model. Even if the housing market stabilizes and recovers, housing prices will no longer escalate at double digit rates from year to year. People will buy a home to live in, to raise a family in, and to slowly build equity over years. This shift from a status to a value perspective has profound implications for the way you design, build, and market your homes.
  - **Learn how to build for less**, **no matter what your price point.** I can't emphasize this point enough. Value is *not* necessarily low cost. We aren't talking WalMart housing here. Regardless of the size or finishes of the home, people at all income levels will be looking to get the most value for their housing dollar. Having said that, you need to also understand that the greatest untapped demand in the market is the lower and mid-level markets, where builders have been unable or unwilling to provide nice, desirable, livable homes at entry-level prices.
  - **Upgrade your level of service.** A home is more than the sum of the components that go into it. The service you provide – in terms of quality control, warranty, and responsiveness to buyer demands is a major part of what you sell to the consumer. Service is not measured purely in terms of absence of problems however. It is more accurately defined as a *response* to those problems. Consumers rate a product higher when it has a problem which is addressed satisfactorily, than when that product never has a problem in the first place. The quality of the response is a measure of the time it takes to get the problem resolved. Again, it is all about attitude.
  - **Embrace process as part of the product.** In addition to a threshold level of quality, buyers are looking for a better *experience* in buying a home. Many people are simply afraid of the custom building process – they've heard all the horror stories of cost overruns, construction delays and endless decisions about every detail within their home. They want the beauty and quality of a custom home – they just don't want to turn their life upside down for a year or more to get it. This is why we recommend that even custom builders streamline the selection process, so that there is a quality default option for each decision, and simple bundles of pre-designed upgrades that are oriented to provide the best value to the buyer. It also means proactive customer communication and scheduling, to avoid those inevitable confrontations when things go wrong.

- **Downsize.** When the dinosaurs were wiped off the face of the earth, one of the reasons the mammals survived was that their smaller size enabled them to better adapt to the changing climate. Builders can adapt a similar strategy, and become a true niche player – one who can survive at the high end of the market by adapting to the reality of a smaller market segment. Examples of niche markets are the highly customized homes tailored to meet a very demanding clientele, infill homes, and tear downs. Builders can specialize in a particular architectural style, such as Craftsman or Victorian, where their expertise gives them greater market credibility. Along with accepting this strategy, however, the builder must also accept the lower sales volume and lower overhead that go with it.

- **Think outside the box.** Being a builder doesn't necessarily mean that you have to build individual residences for individual clients. There are all kinds of ways you can use your skills and abilities and never deal with day-to-day client management issues.

- Build for your own account. Owning rental properties provides a steady revenue stream that can act as a counter cyclical balance to the volatility of the real estate market. Eventually these rental properties can be converted to private residences, or sold to other property managers.
- Do small commercial jobs and build that capacity in your company. Small commercial buildings use many of the same construction skills as residential buildings, though it takes a certain expertise to understand the differences.
- Build for a fee or equity with capital partners on larger projects. On larger projects you may want both an equity share *and* a fee, but expect the partners to contribute the financing.
- Create exclusivity by providing expertise of service that others don't. For example, you could offer design/build services where you handle both the architecture and construction. You could emulate Mark Wilson of London Bay Homes in Florida, who provides high-end total turnkey homes, including furnishings and interior design. You could specialize in a particular expertise, such as design/build, or allergy-free energy efficient construction, where your specific expertise gives you a competitive advantage. You could specialize in the more creative or design intensive elements of the market, and provide services others cannot.

Summary: Your world is changing

Whether you accept it or not, the housing industry is undergoing a profound transformation in structure and direction. It is changing in terms of economics, demographics, and consumer values. In a way it is similar to global warming. We can argue about the extent of global warming, and we can argue about whether it is natural or man-made. But as the polar ice caps melt, and drought seizes huge swathes of the earth's surface, we run the risk of being overwhelmed by events beyond our control. We can understand the changes and plan for their impacts, or we can watch as water levels rise and populations are displaced.

Eventually the economy will rebound, and Americans will be in a mood to satisfy the pent-up housing demand from the past decade. But the means of doing business – the financial instruments, the borrowing ratios, qualification standards will have all changed. And the expectation of the homebuyer will have also changed – to a more affordable, sustainable, livable, and more energy efficient place to live.

The builders who thrive in this crisis will be those who find a way of providing true value to the buyer – better design, higher energy efficiency, more livable spaces – better service, and a better home buying experience, and do it at a significantly lower price point. That's the challenge ahead of us, and those who seize that challenge will see greater demand, stability and profitability than we know today.