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Why Housing Prices Are Nearing Bottom

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Marko Djuranovic
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A recent *BusinessWeek* cover story touted the idea that housing prices could fall by another 25%. Although some areas are looking at a precipitous drop in prices, for the most part, current housing prices are nearing bottom. Forces other than loose lending standards and a corresponding spike in demand are responsible for the recent rise in housing prices, and these have not abated.

These are not your father's houses
The *BusinessWeek* article used an index that tracks home prices as far back as 1890 to conclude that home values have historically risen annually from 0.2% to 0.8% above inflation. Using these trend lines, the article found homes to be significantly overvalued. But there are problems with drawing this inference.

First, today's homes are not the same homes that were built three decades ago. Census data show that in 1973 the median size for a newly built home in the U.S. was 1,525 sq. ft. In 2006 it was 2,248 sq. ft., a 47% increase.

Second, today's homes feature sturdier construction materials, more expensive siding, outdoor additions like in-ground pools, more complex wiring to support an increasing number of electronic devices, sophisticated heating and cooling systems, and larger kitchens (which translate to increased cabinetry). Simply, these are better homes -- and "better" here means more expensive to build.

Third, prices of inputs into the construction process are more expensive these days in relative terms. The bull market in basic materials that started several years ago has raised the costs of construction, and these costs have been passed on to the consumer.

Taking these factors into account implies that housing prices should have grown at least 2% above inflation in the past 30 years, putting the current median home price about where it should be.

Check the margins
The largely fixed expense of building today's homes gets us to the next reason why most homes are probably priced near their fair value. The table below shows gross margins for a collection of eight publicly traded homebuilders. (For homebuilders, gross margins represent the difference between the price at which the home sold and how much it cost to build, inclusive of any land acquisition costs. The cost of superintendents and sales staff to move the properties is not recorded here; it's a part of SG&A and often runs above 10% of revenue.)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
DR Horton (NYSE: DHI)	19%	18%	20%	21%	20%	22%	24%	27%	24%
Centex	7%	9%	9%	10%	11%	10%	13%	14%	13%
KB Home (NYSE: KBH)	20%	20%	21%	21%	23%	23%	24%	27%	20%
Lennar (NYSE: LEN)	N/A	12%	11%	15%	15%	14%	14%	16%	7%
MDC Holdings (NYSE: MDC)	8%	11%	14%	14%	14%	14%	18%	17%	24%
Meritage Homes (NYSE: MTH)	20%	19%	20%	21%	19%	20%	20%	24%	21%
Ryland Group (NYSE: RYL)	19%	19%	18%	20%	23%	24%	25%	27%	23%
Toll Brothers (NYSE: TOL)	23%	23%	25%	27%	28%	28%	29%	30%	26%

Average	17%	16%	17%	19%	19%	20%	21%	23%	20%
Median	19%	18%	19%	21%	20%	21%	22%	25%	22%

Source: Morningstar.com, Yahoo! Finance.

Most homebuilders operate without particularly high gross margins. Although there has been a steady rate of margin expansion since the late 1990s, note that margins in 2006 had already returned to 2003 levels, the beginning of the current housing boom.

Thus, even a 3% drop in prices would bring builders' gross margins well below the levels seen in the previous recession, threatening their profitability. (Land costs, which are not tied to increased costs of construction, would have to fall substantially to negatively influence home prices -- a general rule of thumb is that, for most residential homes, land comprises only 20%-25% of total value.)

This is important because it creates a floor for the price at which homebuilders will be willing to create additional inventory. Buyers will thus be faced with builders willing to slash prices drastically on existing inventory but unwilling to offer similar discounts on future projects.

What does all this mean for the housing market? When the financial institutions rediscover how to assess effectively borrowers' default risks, the supply of existing homes will fall fairly quickly. And the moment that the supply of existing homes begins to shrink, potential first-time homebuyers will realize that between low interest rates and homes that sell at (or below) replacement cost, they can grab the deal of a lifetime.

Objects in the rearview mirror ...
In 1999, tech investors bid up pieces of paper that were backed by fictitious profits of economically stillborn companies. When the bubble burst, the search for the asset's true worth -- often close to zero -- was a painful one. But houses are a different typw of asset; they depreciate slowly and meet a need for which there is plenty of demand: shelter.

Overall, the condition of the U.S. housing market is not nearly as bad as some analysts would have you believe. So, the entire homebuilding industry is worth a closer look.

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