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Homebuilders are at max capacity. And the housing shortage keeps widening

Even with stellar new-home sales, they're not building fast enough to overcome a towering housing deficit

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Everywhere you look there seems to be bad news for the existing-home market — interest rates remain north of 7% and the median home price nears record levels at more than $410,000 as of June.

The dynamics creating that dour landscape for perspective homebuyers eying existing homes are at the same time helping to boost another sector of the home market, however.

New-home sales were up nearly 24% in June year over year, according to the U.S. Census Bureau, after jumping 20% in May. Meanwhile, existing-home sales plummeted by 19% in June year over year after declining by 20% in May, according to the National Association of Realtors.

In a recent earnings call, Sheryl Palmer, chairman and CEO of national homebuilder Taylor Morrison, said about two-thirds of homeowners now have mortgage interest rates below 4%.

"This has driven meaningful share gains for new construction," she added, "with the percentage of new-home listings more than doubling from long-term norms to over 30% of the market."

Fannie Mae's vice president of economic and strategic research, Hamilton Fout, said the gap between homeowners now holding historically low mortgage rates (i.e., below 4%) and today's current market rates has created a so-called "lock-in effect." That's because existing homeowners are "disincentivized to list their homes due to not wanting to give up a mortgage rate much lower than current market rates [and this] continues to suppress the number of existing-home listings," Fout said.

"We believe this lack of existing homes on the market is pushing prospective buyers toward new homes, bolstering sales and construction," he added.

Also helping to propel new-home sales is a huge deficit in existing homes. That shortage is estimated to range from 1.5 million units, according to the Robert Dietz, chief economist for the National Association of Home Builders (NAHB), to some 4.4 million units, according to Fannie Mae — and up to 7.3 million units per the National Low Income Housing Coalition.

"One metric I like is how many jobs are we producing relative to how many housing permits are we producing," said Erik Heuser, executive vice president and chief corporate operations officer at Taylor Morrison. "And as a country, it's 2.6 [jobs for every permit] and the historic average is 1.6.

“And so, as of today,” he added, “we’re producing far more jobs than we are permits, and you’ve got a kind of a baseline structural undersupply.”

Deitz said the “underbuilding” in the home market between 2012-2019 “left us with the housing deficit.”

This year, even with the boom in new-home construction, “we’re expecting a number somewhat below 900,000 for single-family home starts,” Deitz added. “We need to build above 1.1 million to start reducing our deficit.”

“Right now, whatever number you want to believe,” said Brian Hale, founder and CEO of consultancy Mortgage Advisory Partners, “… homebuilders aren’t building enough houses to cover that gap anytime in the next 10 years.”

So, even at the current rate of new-home construction, with demand at stellar levels, the homebuilding industry is still falling well short of the break-even point needed to actually reduce the nation’s housing deficit, assuming the experts are correct.

Peak production

At around 30% now, the homebuilding industry is likely near the peak level of new-home sales as a share of the entire housing market, according to industry experts who spoke with HousingWire.

The homebuilding industry faces a number of operational ceilings in terms of the volume of new homes it can produce annually. Those include material shortages (such as a current lack of electrical transformers and the volatility of wood pricing) as well as shortages of skilled labor, zoning restrictions and available land. In addition, financing challenges due to high rates are disproportionately affecting small and regional privately held homebuilders, which typically rely on debt financing to purchase land and fund construction costs.

Doug Faron is one of three founding partners at Florida-based Shoreham Capital, a privately held built-for-rent (BFR) and multifamily residential developer focused on projects in the Southeast, primarily Florida. He said large publicly held homebuilders, particularly those with affiliated mortgage lenders, do have “cheaper access to capital” and that’s “definitely an advantage in the credit markets.”

“It’s most certainly more difficult in this environment to utilize debt, but it is still very possible,” Faron added. “While it’s much harder [in the current high-rate environment], we anticipate still being able to use both debt and equity capital to push projects forward.”

Deitz said higher interest rates work to constrict the supply of new construction because two-thirds of home construction is still undertaken by private builders. He stressed that “their primary source of capital to acquire land for development and then to build the home before they get the revenue from selling it comes from debt financing.”

Another headwind facing homebuilders is there are just not enough developable lots (or land) in many parts of the country, according to Shannon Faries, director of strategic relationships at Land Gorilla, a provider of construction-loan management software as a service to both the residential and commercial markets.

Dietz concurs, adding that two-thirds of homebuilders say lot inventories are “low or very low.”

“And that’s, in part, because of the regulatory environment [restrictive zone rules],” Faries said. “In addition, all these banks that have traditionally made those [land-acquisition] loans are not making quite as many of those loans as they used to because there’s stress in the banking system.

“So that’s a further headwind. How are you going to build millions of homes if you can’t get the financing to develop the lots in the first place?”

Faron of Shoreham Capital said there are still plenty landowners out there willing to sell properties. “But the question is,” he added, “at what price?”

“What has made it much more difficult is the cost of capital,” Faron explained. “It just means you have to look that much further.

“Before [when interest rates were much lower] maybe there were 10 land sites that worked [cost-wise], but now there’s only one, and you have to find that one.”

Dietz explained that lumber/materials, labor, land and financing are all “limiting factors” on the supply of homes in the country.

“You can’t just solve one to solve the whole problem,” he stressed. “The better way of saying that is that there’s no simple, scalable solution to the housing shortage.”

Bigger is better for homebuilders

Heuser at Taylor Morrison concedes that big national homebuilders have some built-in market advantages, adding that the perks of being big are leveraged by publicly held homebuilders to expand their market share.

“I used to own a small homebuilder, so I am all for small homebuilders, and I think that they will always be part of the housing ecosystem,” Heuser said.

He added, however, that large public homebuilders have a leg up in access to capital markets as well as in land-acquisition efforts because they “tend to get early looks and are going to get those favored [land] deals.” He added that the publicly traded homebuilders also have an advantage in attracting more of the skilled labor pool in a market where labor is still scarce; in purchasing power due to scale dynamics; and in “consumer mindshare” due to the visibility of large builders in local markets.

Taylor Morrison operates across 11 states in the West, Southwest and Southeast through several brand names — Taylor Morrison, Esplanade, Darling Homes and Yardly. Heuser said

the homebuilder currently has about 5.8 years' worth of owned or controlled land for future housing development.

"And we've increased our projected land spend for this year from $1.6 billion to $1.8 billion," Heuser added.

"So, you add all those things up, and you just get a generally a competitive advantage," Heuser said. Plus, larger homebuilders like Taylor Morrison, via its affiliated mortgage lender Taylor Morrison Home Funding, can offer attractive buydown rates to perspective homebuyers.

"Either we can just put a big incentive on the home [such as free hardwood flooring or other finishing upgrades] which is kind of a one-time thing, but then they still have a higher interest rate over a period of time, so it's less affordable," he explained "Or we can create a systemically lower mortgage rate, which on net should be a win for them and a win for us.

"… A [permanent buydown] rate in the 5.5% range seems to be the trigger point for the consumer today," Heuser added, "because they know rates will never be 3% again, and they don't like 7%, but 5.5% they can swallow."

Hale said larger homebuilders may make a little bit less per home by offering incentives such as rate buydowns, but their velocity of sales picks up as a result of the bargain rates, and that allows them to still make a healthy profit.

"So, the homebuilders with a mortgage entity are using that mortgage entity to offer temporary or permanent buydowns or both, and making it very accommodative for the buyer," he added.

Deitz said the big national builders that are publicly traded companies and vertically integrated with lending arms and land-development companies "account for maybe a third or so of total single-family construction [volume based on units]."

"Those national builders are more likely to be engaged and orchestrate buydowns," he added. "And our estimates are that maybe about a third of builders nationwide are actually engaged in mortgage rate buydowns.

"… It has been an advantage," Deitz said, "and it does offer the builders an opportunity to gain some market share in a market with elevated interest rates."

Build-for-rent

The tailwinds pushing up new-home demand and sales for now include the lock-in effect created by high interest rates and still-high home prices; a growing housing deficit in the face of still-strong homebuyer demand; favorable demographics ahead due to the huge volume of baby boomer and millennial homebuyers; and the ability of homebuilders with captive mortgage companies to offer attractive buydown rates.

None of that is permanent, however. Dietz said the favorable demographics existing today, for example, will give way to headwinds in the 2030s as the generations following the baby boomers and millennials are much smaller.

Likewise, industry experts said interest rates will likely come down in the not-to-distant future, and that will eventually restart the existing-home sales engine — whether that's next year or in 2025. That, in turn, will likely soften demand for new homes — or at least make it harder for new-home sales to expand as a percentage of overall sales.

Another important factor propelling new-home construction for both small and large homebuilders that some argue is better insulated from the rate environment, however, is the still-growing build-for-rent (BFR) market.

Heuser of Taylor Morrison, which operates a BFR brand called Yardly, as well as Faron of Shoreham Capital both remain bullish on the future of the BFR market.

Heuser said Yardly currently controls some 7,200 lots across 30 BFR communities, with about half already under development. He described Yardly as an "evolving business," which was launched three years ago.

One of Shoreham Capital's business partners, Nick Zoumas, is the founder and president of JNS Homes, a Florida-based homebuilder. Shoreham, a BFR and traditional multifamily developer, has broken ground on some 600 units — the bulk of which are single-family BFR homes — and has some 1,500 additional units in the pipeline.

Heuser said in total there are about 15 million single-family rentals in the country currently, of which only about 4% are owned by large institutional players, such as real estate investment trusts, or REITs. However, BFR production accounts for about 5% of annual new-home production now, "or about 70,000 units a year across the United States," Heuser added, and its growing.

"Incomes are up 12% since 2020, but home prices are up 24%, and given what's happened in mortgage rates, the monthly mortgage is up 74%," he said. "So, that just means not everybody can afford a new house, or a house altogether."

Heuser said the Taylor Morrison's goal is to eventually sell its BFR communities to investors, adding that "the nice thing" is you are still generating revenue from the properties prior to such as sale. "You're getting rental income, and so you've got some optionality in terms of the exit," he explained.

Faron of Shoreham Capital said there has been a slowdown in the BFR sector in recent months "because it's harder to get deals done with the changing cost of capital." Still, he said Shoreham Capital has remained productive, "still able to get things done because we're very focused on location, and we're in this for the long-term."

"Whether rates stay high and there's more demand because of a lack of housing affordability, or rates go down and it makes our [BFR] projects easier to pencil out [because lower rates equal

lower development costs], we think it will be a growing segment over the next five to 10 years, regardless," Faron said. "There's more demand [for single-family homes] than supply.

"That's honestly why a lot of institutional investors are continuing to like this segment … [because it] is agnostic with respect to what's happening with rates."