5 TRENDS SHAPING NEW HOME DEVELOPMENT IN CALIFORNIA

A look at factors contributing to the future of new real estate in the Golden State

California Builder Services

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America's population has grown two to three million people every year since 2000. If that number were divided evenly among each state, that's roughly 40,000 to 60,000 added to each state. So while it's not the case that Wyoming and Florida have the same population growth of essentially a large town each year, it's safe to say that states welcoming more residents will need more housing. For example, since 2000, California has ballooned in population by nearly six million. Put another way, over the last 20 years, the Golden State has added two Chicago's to their population.

It's no wonder that new home development is on the rise in California. However, the state is known for its extensive residential and zoning rules. The Davis-Stirling Act has 11 chapters and over 200 code sections for residential association developments to follow. Furthermore, you can be penalized if you fail to comply with the rules. Fines can range anywhere from $25 to $100, depending on the situation. California Senate Bill 9 will require a city or county to adopt a general plan for land use development within its boundaries that includes, among other things, a housing element. Additionally, it would require a proposed housing development containing no more than two residential units within a single-family residential zone. That's essentially the end of single-family home zoning.

That said, the California real estate market landscape is changing through governmental actions and the necessity of the nonpolitical factors at play. Here we'll discuss the five trends shaping the future of California housing development projects in 2022 and beyond.

1 Environmental Wildcards

Insurance premiums and development risk will continue to rise because of environmental wildfires

First off, temperature variation across the state plays a crucial role in new housing development and homeowner associations. An HOA near the Oregon border will have a much different outlook than one within minutes of Mexico. Environmental factors play a crucial role in residential real estate with snow in the north, heat in the south, mild temps year-round by the bay, and wildfires inland. New home developments — and the rules, regulations, and insurance they'll need to comply with — rely on where in the state the home / HOA is located. Wildfires impact insurance costs. The insurance price is a significant concern for Californians who live in high-risk zones, as insurance premiums have risen anywhere from 300 to 500% since 2019 in those impacted areas. Plus, over 340,000 policyholders have had to terminate their insurance within the past four years due to a rise in prices.

Remapping of fire zones is taking place in California to better prepare residents and HOAs alike. The local Fire Department will inspect these properties to determine the potential risk in the case of a wildfire occurring in the area. However, the concept of defensible space (weed removal, creating a firebreak if the homeowner is in a higher risk fire zone) may be the responsibility of the HOA and may have to be included in the annual HOA budget.

Climate change, as it differs from temperature variation, also impacts the state. For instance, the climate is becoming a lot drier in certain areas, leading to record droughts and damaging wildfires from forests that only take a spark to ignite a raging wildfire. The temperature in Palm Springs rose to 120 degrees this summer, raising questions about the safety surrounding construction workers building homes during the blazing summer months.

Adding to the previous point, environmental factors are calculated when searching for the appropriate location to build within the state. For example, Lathrop, California (just south of Stockton), was known for its small population and open fields. It has been replaced by warehouses and Silicon Valley commuters who moved into this small town as they were unable to take on the brunt of living in San Francisco. (NYT). Places like Lathrop and others in the Central Valley will see an incredible appreciation in value. We'll discuss the rise of the Central Valley later on in this report.

Takeaway: Wildfires and climate change will significantly impact insurance prices across California

2 Construction Costs

Construction costs are going to fluctuate, leading to an abundance of creative building methods

There are plenty of factors at play. But regardless of the cause, material price fluctuations represent a profound and lasting risk to construction projects. Fluctuations are causing spikes in construction costs and threatening to delay project completion dates. As a result, materials need to either be rationed or assigned to only specific priority projects—or materials are just not available at all. This instability in market certainty is creating a "schizophrenic housing market" in terms of construction costs.

Economic shifts exacerbated this trend due to the COVID-19 slowdowns and financial strains that followed shortly after that. According to the National Association of Home Builders, increased lumber prices added roughly $24,000 to the cost of building a new home in summer 2021. Lumber prices were up 249 percent from mid-April 2020 to mid-June 2021. However, the essential construction material was up by more than a 400 percent margin when measured from mid-April 2020 to mid-May 2021. Now, lumber prices are dipping back down closer to pre-pandemic levels. In the coming years, I anticipate more frequent fluctuations in construction costs—from lumber to drywall to concrete. Even the price of paint is up 10 percent (ABC News)! HOAs remodeling or having to renovate will have a tough decision ahead of them if this becomes the case: will they charge somewhere in the projected middle to make up for the rapidly changing costs or raise dues when prices move outside of a certain range, such as a 5 percent change? This will be up to the HOA board and the voice of the residents, but it'll undoubtedly make for an interesting new take on the system of how HOA fees are handled. Some self-managed HOAs will likely make the disappointing choice to defer the necessary maintenance.

Labor shortages will also play a key role. In mid-July, CNN reported that America needed one million construction workers, accounting for approximately 10 percent of the labor shortage at that time. In California, labor shortages for construction firms have been an ongoing issue and continue. A recent survey from the Associated General Contractors of America and Autodesk shows that the vast majority of construction firms in the state have open jobs they cannot fill. More than 3 out of every four firms are having trouble filling both craft and salaried positions.

One solution to combat this would be to relieve construction costs and worker shortages through off-site or modular construction, which entails planning, designing, building, transporting, and assembling components away from the actual housing site. In turn, this allows for an area without a worker shortage to complete the job, typically making the entire process faster despite the transport process. These constraints are creating the necessity for project managers and building contractors to seek even greater efficiencies to keep costs down while still meeting the desired quality-to-amenity ratio desired by incoming homeowners.

Takeaway: With supply chain and labor uncertainty, builders will get creative

3 Updated Building Codes

New building codes are here, more will emerge, and builders will adapt

The California Solar Mandate is a building code that requires new residential construction (single-family homes and multi-family up to three stories) to have a solar photovoltaic system, or PV, as an electricity source. For example, a stove, water heater, and a furnace will all have to be powered by solar electricity. The mandate went into effect on January 1, 2020. California has become a pioneer in pushing solar power. The state gets plenty of sun, which allows it to include these regulations in new construction. Under the current law, homeowners will need to build a solar panel into the house. In addition, homeowners will need to wire a 220-volt plug directly to their unit for electric vehicle charging.

While this will initially be an added expense for homeowners, it will be an investment in the future for a safer and well-maintained environment. This will pave the way for neighborhoods and individual homes to be viewed through a different lens. I can easily envision subdivisions becoming a sort of "energy farm" for those residents rather than having to tap into the current electrical grid. This would cause a greater sense of homeowner autonomy by generating electricity through renewable conduits such as solar power.

On top of legislation that will improve the efficiency and greenness of housing in California, the state requires more houses to be built to help combat the homelessness crisis in major cities, particularly the Los Angeles area, in the coming years. This will most likely come in the form of housing projects within the city to alleviate individuals who have been unable to make ends meet to secure consistent shelter.

A historic piece of legislation just signed into law in September 2021 has the potential to transform development, particularly residential building in subdivisions. Governor Gavin Newsom signed into law Senate Bill 9, which eliminates single-family zoning in the state of California. The law allows up to four dwellings (two duplexes or two houses with attached units) to be built on any lot that is currently in a single-family residential zone. There are very limited exceptions for cities and counties to veto it when there is a “threat to health and safety.” Historic districts and fire hazard zones are excluded too.

While the bill is controversial because it limits the ability of local governments to plan their own zoning, it will no doubt transform development in the state. Time will tell how developers react and what the impact will be, but it may allow developers to build townhomes in areas they otherwise wouldn’t, and it could potentially reduce the cost to purchase a home in some areas where home ownership is out of reach for many middle-class Californians (although there are no provisions in the bill that require new housing to be affordable).

Takeaway: Keep an eye on new (and future) building codes

4 Action Inland

Continued boom in the Central Valley and Inland Empire

According to the San Bernardino Sun, in late August 2021, home prices have advanced by impressive margins in the Inland Empire over the last 12 months—this is the area to the east of the major coastal cities in Southern California, with the cities of Riverside and San Bernardino serving as its hub. There has been a steady string of double-digit percentage gains in the region's median home price since July 2020. In July of 2021, median home prices were up 26 percent year over year, with the most recent July 2021 median up 26 percent year-to-year to a new record high of $529,000. Home sales have been up too—up 19 percent in the first part of 2021.

Other more populated parts of California have not been faring so well. Take rent prices in San Francisco: They are still down 5 percent year-over-year as of August 2021, according to RentCafe. Some people with the freedom to move and work remote or in a hybrid setting have taken advantage of the current economic situation, leading to families and individuals opting to move inland, from Palm Springs all the way up to Sacramento.

Earlier this year, the LA Times named Fresno, California, the hottest housing market in the nation. New developments are in part fueling growth in the region. There were a total of 13 new public reports for new developments filed in Fresno County in 2015, according to DREPublicReports.com. That number was up to 20 in 2020—that is a **54 percent increase** despite the pandemic. In neighboring Madera County, there has been a surge in new developments. One of the developments we're working on is a more than 6,500-home new development across the street from a more than 4,000-home development.

Kern County, with its county seat of Bakersfield, has traditionally been farmland and a rural county. But new developments have boomed in this part of the state, too. In 2015, there were 12 development reports filed with the state. In 2020, the number was 49. That's a remarkable **308 percent increase**!

Perhaps the most drastic example of the new development boom is in Merced County. Sandwiched in the northern San Joaquin Valley of the Central Valley between Fresno and San Jose, **Merced had 0 new development reports filed in 2015. In 2020, there were 36**! Many have said that Merced bore the brunt of the Great Recession in California. But, obviously, it's recovering!

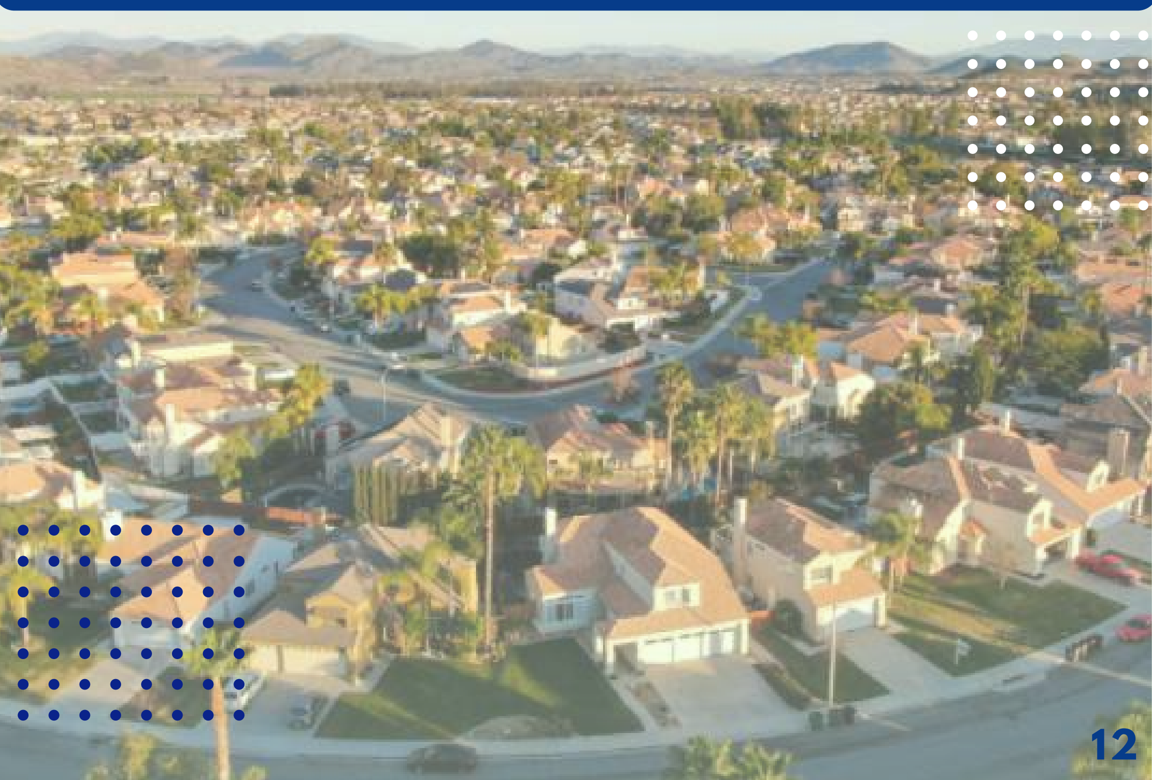
New construction in small cities and suburbs around central California rose 15 percent, compared to less than 10 percent in large cities. A May 2021 headline in the New York Times sums up the conundrum facing builders: "House Hunters Are Leaving the City, and Builders Can't Keep Up" (NYT).

Development is booming in the Central Valley as a whole. We've seen this firsthand as a DRE Public Reporting, HOA Budget and Reserve Study firm located near Fresno. We work with developers around the state to develop new residential subdivisions. There are multiple 500 unit + developments in the Central Valley from Bakersfield to Sacramento, and there are many other examples of these communities across the state.

The reason there's so much demand in the Central Valley is pretty simple. It's more affordable, and there's more open land to develop compared to the Bay Area. A home buyer can purchase a 3,000 square foot home in Fresno for the same amount as a 500 square foot studio in San Francisco.

There is a large swath of homeowners who really like being within striking distance of big cities, but not necessarily in the heart of the action. The Central Valley fits this description to a T, which is why new neighborhoods are sprouting up across the region.

Takeaway: Inland is where it's at right now for development



5 Communal, Co-Owned Living

Multi-family starts may not bloom for a few years, but TICs are in

While single-family housing starts in California grew in 2020 (albeit by just under 1 percent), multi-family starts were down significantly, experiencing a 9 percent decline in 2020 compared to the previous year. This is partly due to construction challenges during the pandemic, but also from zoning regulations in local communities or potentially the "not in my backyard" mentality of some communities not wanting an apartment complex in their suburb. Whatever the reason, multi-family starts experienced a pretty substantial decline in California during the first year of the pandemic.

According to First Tuesday Journal, this stagnant multi-family trend may continue for some time because of job losses during the pandemic and the expiration of foreclosure and eviction moratoriums that were essentially helping people stay in the home who were delinquent on mortgages. As a result, builders may not want to take on the risk of developing a multi-family building until they see that recovery is well on its way and we are past any fallout from those moratoriums being lifted.

While new development may not bloom for a few years, multi-family homeownership is increasing rapidly in highly populated urban areas through tenancy in common (TIC) developments.

TICs are a kind of legal, co-ownership form of communal living where a buyer buys into a shared space with two or more owners. Each buyer owns an equal—or unequal—percentage of the underlying Lot (i.e., four tenants each own 25% of a property and either pay in cash or take out mortgages on the amount they own) and exclusive rights to their private dwelling space. Everyone owns a percentage of the entire property, so all share group spaces (like a nice outdoor hosting area). This is attractive to Millennials, particularly those who went to university and experienced dorm room living and want to maintain a sense of community and have ownership in a unit. TICs are a way for people who otherwise couldn't afford the hefty mortgage in a place like San Francisco to at least own a portion of the property they reside in.

The Road Ahead for Developments in California

Financial uncertainty and material cost fluctuations in the system will drive many families to not think about the long-term investments associated with homeownership and prioritize merely renting for the short term. However, this becomes a long-term strategy if it isn't revised. This trend was already present for Millenials, as they saw their wages stagnate and real estate costs exceeding these wages. Thus, it made homeownership a much more costly venture compared to their parent's generation. Gone are the days of feeding a family of four off of one parent's income and being able to keep up with mortgage payments for your cookie-cutter house in California.

In the short term, government stimulus and recovery measures for the housing market in 2020 were able to salvage a market that could have otherwise been on the brink of another 2007-level collapse. Analysts note a housing correction every decade, meaning that the pandemic's effect on our housing market was "perfectly timed" given a correction was seemingly around the corner regardless.

This stagnation can and will impact multi-family starts for the next few years. However, from that point, a few years down the road, the housing market will be in a new cycle to grow for approximately the following decade. So from 2023 or 2024 until the mid-2030s, we could see steady growth in multi-family starts in California, particularly to house a new generation of Gen Z's ready to either rent or own a place. This will be coupled with growth in the rate of homeownership among Millennials. Although, yes, the foreclosure moratorium helped many working and middle-class families throughout the pandemic, there are likely to be fewer long-term benefits for educated Millennials looking to upgrade their living situation—unless they look to the Central Valley and Inland Empire, more affordable places to live in the state.

Increased wages and perpetually lower interest rates will be driving factors that would aid this generation in buying more homes as they grow their families, especially given the lower birth rate. The birth rate dropped 4 percent in 2020, and according to data from Morning Consult, nearly 3 in 5 childless millennials say they don't have kids because it is too expensive to raise them. So more minor children will mean more disposable income to pay for a mortgage, at least theoretically. And if this trend continues, we may see new residential development climb in a few years when the constraints of the pandemic are almost fully in the rearview mirror and builders adapt to the demands of the next generation of homeowners.