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Builders will have to cough up money if they want to stay competitive with the swelling inventory on the market. DAVID PAUL MORRIS/ BLOOMBERG NEWS

Home Builders and Sellers Vie for Buyers

Competition is heating up, which will force companies like Lennar and KB Home to beef up incentives

Ready to be realistic about the value of your home now that mortgage rates are above 7%? Builders won't thank you for it.

Home builders had one thing working in their favor over the past four years: Regular home sellers weren't willing to budge on prices, so competition from the existing home market was low. This is starting to change, which will hurt builders' already diminished profit margins.

Lennar and KB Home said recently that they are facing tougher competition from regular owners who are more motivated to sell. The average price Lennar sold homes for in its west region over the three months through August was \$44,000 lower than the same period last year—a 7% drop. Average prices in its central region dropped 5% compared with a year ago. It said stiffer competition from the existing-home market was one factor behind the declines.

KB Home lowered the midpoint of its average sales-price estimate for the fourth quarter from \$500,000 to \$480,000. Southern Californian home sellers are cutting their prices to entice buyers, so KB Home has to follow or risk missing out on sales.

Note
In the four weeks through Sept. 20, 21% of sellers in the existing home market dropped their asking price, data from Redfin shows. The most significant activity is happening with concessions, which don't show up in headline prices.

In August, 45% of home sellers gave concessions to buyers, such as offering to cover the closing costs or handing the buyer money for repairs. In oversupplied Sunbelt markets such as Atlanta and Nashville, Tenn., 7 in 10 sellers are now offering concessions. These are the same markets where home builders tend to cluster.

Note
Outright price cuts are likely to become more common because the number of homes for sale is almost back to prepandemic levels. In September, inventory was 5% below the same month of 2019, according to data from Realtor.com.

The pandemic-era housing boom sent the usual competitive dynamic between the new-home and existing-home markets haywire. Last year, sales of existing homes were one-fifth below 2022 levels. Note

Once mortgage rates began to rise four years ago, owners with ultralow rates stayed put, starving the for-sale market of supply. And many sellers had a "here is my price, make me move" mentality. They preferred to take their property off the market rather than accept a lower offer. Note

That suited builders nicely.

Note
They stepped in to fill the gap in existing-home inventory. Sales of new homes rose 7% between 2022 and 2025.

Large builders were able to keep selling homes because they could offer a mortgage-rate buydown. Over the past few years, anyone buying a new home from a builder has been able to get a loan that is 1 to 2 percentage points lower than what she or he would get from a primary lender.

Note
The downside is that the buydowns are expensive and have sapped profit margins. Lennar currently has to offer incentives such as rate buydowns worth 12% of the value of a home to get deals done. In the three months through August, the company's gross margin was 15.8%—back at levels last seen in the aftermath of the 2008-09 financial crisis.

Things might get worse. Higher mortgage rates make it costlier for builders to buy forward commitments from lenders, which is an agreement to buy mortgages in bulk at a below-market rate. Note

At the end of last year, a builder had to pay \$3.8 million to buy down the rate from 6% to 5% on a \$100 million forward mortgage funding commitment, according to Edward Pinto, director of the AEI Housing Center.

Today's higher mortgage rates have pushed the cost of buying down the rate by 1 percentage point on that same \$100 million forward commitment to \$5.4 million. Builders will have to cough up the money if they want to stay competitive with the swelling inventory on the market.

Builders and regular sellers also are fighting over a shrinking pool of buyers. Demand has nosedived since mortgage rates rose above 7%. Sales of new homes per community in September normally slow by 4% on average compared with August as the buying season winds down. This year, sales fell 18%, according to Rick Palacios, director of research at John Burns Research and Consulting.

Berkshire Hathaway has been making contrarian bets on builders this year. It paid \$6.8 billion in May to buy Taylor Morrison. In September, it took its stake in Lennar above 10%. This isn't a sign of an imminent recovery for builders. Berkshire is buying in a tough neighborhood with confidence it will improve over the next few years.

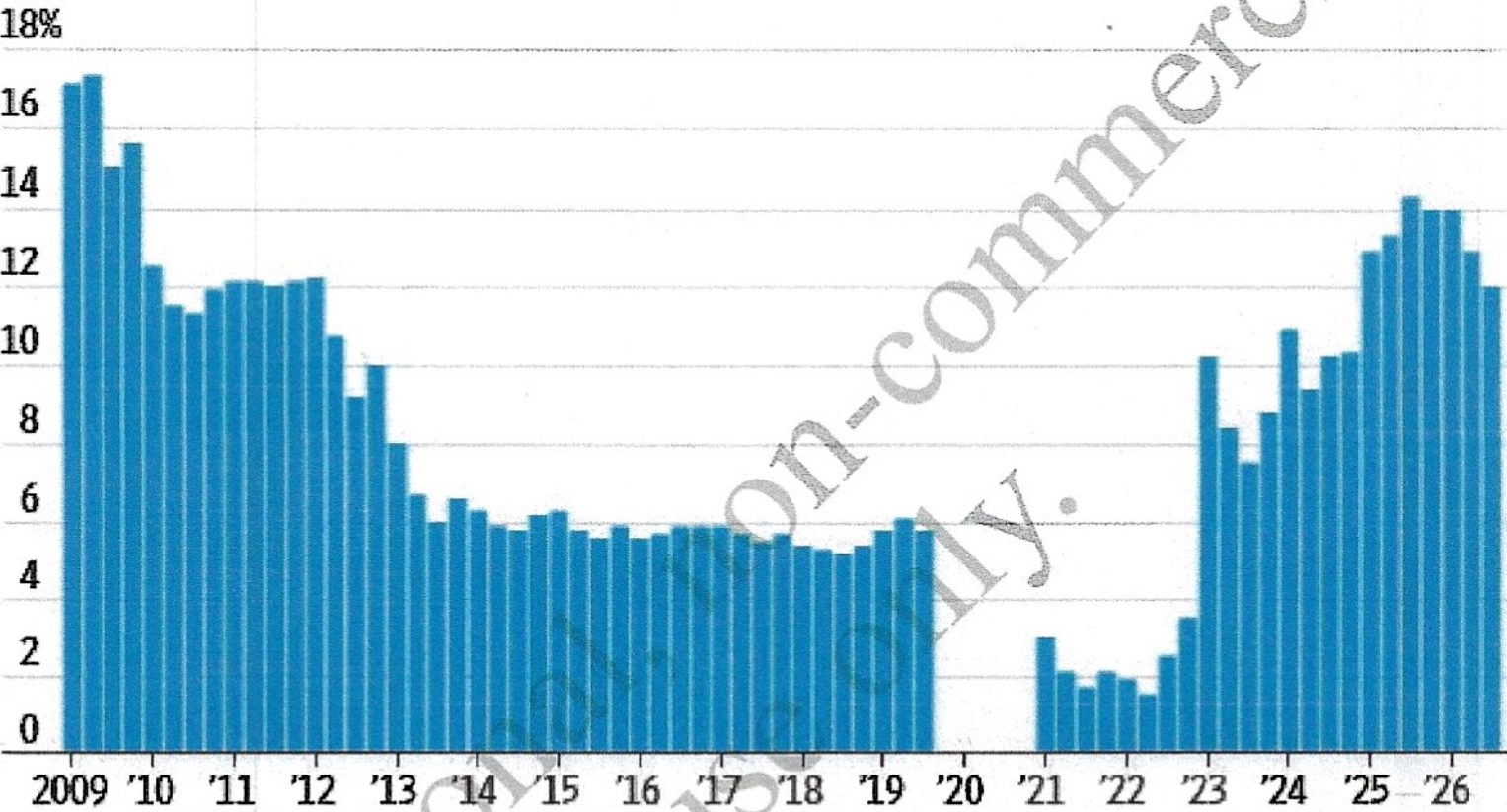
There is still a shortage of housing in America. And UBS home-builders analyst John Lovallo points out that harsh conditions in the housing market are forcing builders to become better operators. Several whittled their construction times down to record lows.

That's a long-term bet. For now, the outlook for builders is tough. Mortgage rates are moving in the wrong direction. The last thing they want is a price war with regular home sellers. But it looks like there is one on the way.

Carol Ryan

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Sales incentives on newly built homes as a percentage of revenue for Lennar



Note: No data available for 4Q 2019 through 4Q 2020 due to Covid-19 pandemic.
Source: John Burns Research & Consulting

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