HOW A BOOM CAN SEND YOU BUST

CASHFLOW ISSUES IN THE RESIDENTIAL HOME BUILD SECTOR

A housing boom that's tough on the residential home build sector reads like an oxymoron, but high competition, price volatility and large overheads make it tough going for many companies.

Article by Matt Marshall
STAPLES RODWAY TAURANGA
matt.marshall@staplestga.co.nz

WITH BUILDERS BOOKED OUT FOR months in advance, and a major housing shortage, we can be forgiven for assuming the building industry won't slow down for some time. However, that doesn't mean the industry is flush with cash. Cashflow issues are rife and remaining 'cash positive' is more vital than ever.

In our experience the three key factors to keep builders in the black are billing structure, margin and breakeven point.

THE BUSINESS MODEL

Margin

We are all aware that the 'kiwi way' is to get three quotes for any major renovation or build and generally opt for the cheapest. This has led to a very competitive market and a resulting drop in margin for many companies.

The main residential home build sector is now dominated by large housing companies, and the business model for many of these companies is high sales volume, low-mid margin. Often, they have high overheads to cover (including management salaries, significant marketing spend, construction managers and finance costs) and the high volume turnover is necessary to continue to cover these costs. If sales volumes drop for an extended period the company can soon run into issues covering these overheads, and we have seen examples recently of housing companies falling over.

Price Fluctuation

Another issue facing the housing industry is fluctuations in costs – both in land and materials. The latest QV cost builder six-monthly report* shows the average cost of building a new home has risen by 30.7% since 2007. The issue is that often these cost increases may be unable to be passed on to customers quickly enough, due to existing fixed price contracts.

The companies that offer houses and land packages take on a calculated risk when it comes to the price of land. Companies that turn houses over quickly do well, however often subdivisions are sold one to two years prior to houses being sold. An agreement to purchase 10 lots at $300,000, with an on-sell value of $320,000 makes sense, but if the land value suddenly drops to $280,000 the price of the house and land package needs to increase significantly or you're faced with absorbing the loss. On the flip side, if the land value increases those 10 lots become very profitable.

Billing Structure - Cash is King

In the building industry cash is king. Any successful company relies on a steady stream of cash coming in to cover the outgoings. The construction of a residential house generally has certain billing points, for example "ready to roof stage", which means housing companies are incurring costs such as labour and building materials which they need to cover before a billing point is reached (unless the up-front deposit is sufficient to cover this). At any one point you could have multiple jobs that haven't reached a billing point, combine this with the fixed overheads and you've got a large cash outflow and high working capital requirements. Managing the billing points on multiple jobs to keep cashflow regular becomes key.

Job Tracking

The timeline for a house to be built could range from six to twelve months, with multiple builds on the go you need a system that allows you to review how much profit you are making each month.

Each house that is built needs to be carefully planned and priced, therefore you also need the ability to track how the job is progressing and whether you are meeting budget. A quality job costing system is a key tool for monitoring progress.

KEY TAKE-OUTS

Successful housing companies remain cash positive by focusing on key items such as billing structure, margin and breakeven point/volume requirements.

- Review your target margin and stick to it. Avoid negotiating below this point. Five quality jobs with a good margin can be better than 10 jobs won by negotiating down on price and making poor margins.
- Know your breakeven point. How many houses do you need to build over a period to cover your fixed overheads before you are making a profit in that period?
- Aim to be cashflow positive on every job by reviewing your billing structure. If a build has four billing points then consider what the optimum spread is of these billing points to keep working capital requirements down (therefore saving on costs of capital).
- Track your costs by maintaining a quality job costing system that can record costs on a job by job basis and allow you to monitor multiple jobs on the go.

If you have any questions regarding the residential home build sector, contact Matt Marshall at matt.marshall@staplestga.co.nz, or your usual advisor.

*QV Cost Builder, 2018