

MARKET UPDATE

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HOME LOANS

 BUILDERS ASSOCIATION
OF THE TWIN CITIES
PROFESSIONAL HOME BUILDERS & REMODELERS

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About this Market Update...

The Builders Association of the Twin Cities is proud to present the 2007 BATC Market Update. This is the first ever issue in what will be an annual publication. The goal of this update is to reflect on what has occurred in the Twin Cities housing market over the past year — including demographic changes, existing real estate and construction activity.

Hopefully, this update is informative and useful in your business planning over the course of 2007.

Please let us know if you have any questions or comments about this publication.

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2006 in Review

Through the first part of this decade, those involved with residential construction were the beneficiaries of some of the best years in history. New activity, price growth, and sales were at record highs. A sharp increase in success led to much speculation about the future housing market and whether or not there was a “bubble.”

The truth is that building activity in the Twin Cities slowed down significantly in 2006 - but this is a trend that was both expected and necessary. Through recent years, the market has moved at an unsustainable rate. This pace caused production to outperform demand and inventory rose to unsteady levels. Essentially, the slowdown in 2006 was a correction that the market needed to scale back new supply and shed built-up inventory.

2003 was the peak year of residential construction activity, when 19,000 new units were permitted in the Twin Cities region. Over 18,000 units were permitted in both 2004 and 2005. Estimates show a market need of about 16,000 new units annually in the Twin Cities. This is the sustainable rate of production, and a rapid rate of production through the peak years overshot this need. In 2006, building activity sharply declined to 12,644 permitted units. While this is troubling at an initial glance, it really is only a correction from an overly accelerated pace. The

industry simply reached the tipping point for new construction and needed to take a step back to revise strategy.

Many builders did take 2006 as an opportunity to take a breath, switching gears from creating new supply to selling existing inventory. Homebuyers found a variety of choices at historically low interest rates with some homes even offering incentives. Of course, these incentives are just a footnote to one of the largest developments in the market over the last year: a shift to a buyer's market. During the first half of the decade, many became concerned about housing affordability. One of the long-term benefits of the current slowdown is that it will help curb price growth to more historical rates and give buyers a chance to catch-up to the market.

The Twin Cities market has changed in 2006, and the record years are gone for the time being. The best strategy for now is to gain understanding of how to effectively operate in this changed environment.

In the following pages, you will find a walk-through of demographic and market information from the Twin Cities metropolitan area. This is a review of what has happened in the market through 2006, with a brief outlook towards the future.

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The Year in Quotes

“Housing markets across the country have cooled, as predicted, and builders are aware that some slowing in demand is inevitable following the record breaking sales for the past three years. While the recent decline in mortgage rates helped buoy builders’ confidence, they are adjusting to the changes they are seeing and hearing in their sales offices.” David Pressly, NAHB President, January 2006

“What we are seeing could best be characterized as a return to normalcy. The record-breaking sales and price appreciation of the last 5 years were unsustainable, and we are now entering a more mature and balanced market.” Todd Shipman, 2006 Minneapolis Area Association of Realtors President, March 2006

“The entire housing market is experiencing a slight rebalancing. It’s important to understand that this shift – from a frantic pace to a normal pace – is necessary for our market to position itself for long-term stability and growth.” Curt Swanson, President of Swanson Homes and 2006 BATC President, April 2006

“We are coming off a very strong couple of years for the housing industry and markets are now starting to cool to more sustainable levels. Each market has different factors that affect its local economy and housing market, but overall we are forecasting an orderly slowdown in housing starts.” David Seiders, Chief Economist, National Association of Home Builders, July 2006

“While the housing market is not on the same path that it was in the earlier part of the decade, the footsteps are familiar. This is simply another phase of the market cycle as different parts correct and mature.” Nate Duoss, Builders Association of the Twin Cities, November 2006

“This year has been down considerably, but not because builders are calling it quits. For a long time we focused on building to the point of excess and this year we’ve focused on selling that excess. I am confident that this responsible behavior will result in a better outlook next year.” Curt Swanson, President of Swanson Homes and 2006 BATC President, December 2006

Twin Cities Population

Annual Population Estimate by County

	2001	2002	2003	2004	2005
Anoka County	305,486	310,162	314,088	319,548	323,996
Carver County	73,280	76,075	79,047	81,851	84,864
Chisago County	43,232	44,947	46,724	48,253	49,400
Dakota County	363,722	368,750	373,184	378,343	383,592
Hennepin County	1,122,996	1,120,208	1,119,949	1,119,866	1,119,364
Isanti County	32,640	33,897	35,463	36,526	37,664
Pierce County (WI)	37,086	37,420	37,916	38,449	39,102
Ramsey County	512,021	509,374	504,477	499,206	494,920
Scott County	97,534	103,813	108,896	114,765	119,825
Sherburne County	68,359	72,262	75,375	78,621	81,752
St. Croix County (WI)	65,833	68,420	71,279	74,234	77,144
Washington County	207,287	210,380	213,983	216,153	220,426
Wright County	93,920	98,432	102,874	107,062	110,730
13-County Region	3,023,396	3,054,140	3,083,255	3,112,877	3,142,779

Source: US Census Bureau

Population continues to shift to outer ring counties and suburbs, with some of the fastest growth located in these areas. While building activity in the central cities has picked up in recent years, there is still a shift in growth occurring outwardly.

Much of this is a result of land costs that have escalated in the inner core of the metro area. Land costs have increased due to market forces of supply and demand, but also from increasing costs of development. Increased development costs are a result of restrictive land-use policies at the local level. These are ultimately reflected in the final cost of a home, meaning that restrictive policies in the region's core are further pushing population outward.

Of course, outward growth is also market driven. The Metropolitan Council estimates that the Twin Cities region is estimated to grow by almost a million people between 2000 and 2030.

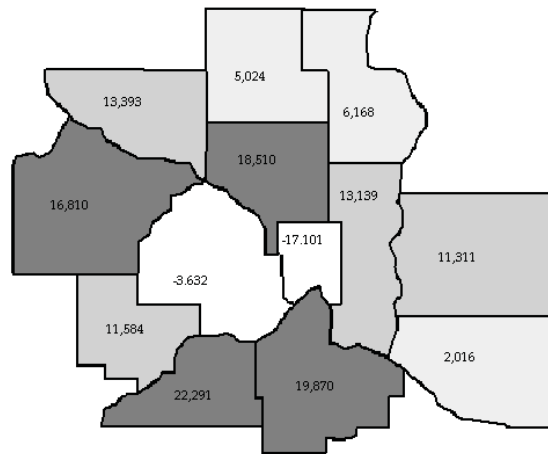
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This influx of new residents is going to drive demand in this housing market and necessitate almost 470,000 new housing units during that time. A majority of population growth will continue to occur in suburban areas, following both existing jobs and expected future employment growth. The trend is already apparent. As Fortune 500 companies have located headquarters in the suburbs—mostly around the 494/694 ring—so housing growth has followed likewise.

In addition to following job growth, the market has pushed population growth outward due to lifestyle choices. A segment of the population finds suburban and exurban life very attractive. There is room for larger homes, big backyards, and opportunity to live encompassed by open

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2001-2005 Net Change



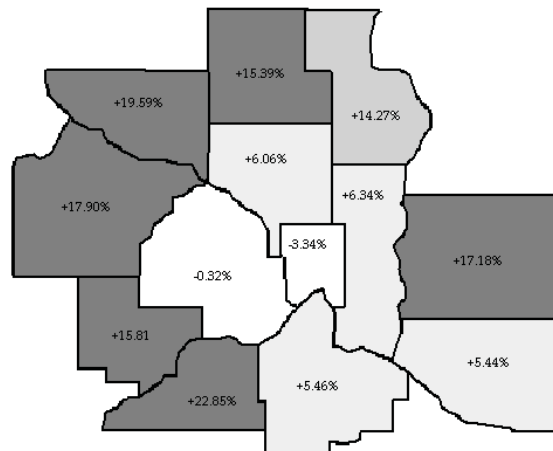
Anoka County	18,510
Carver County	11,584
Chisago County	6,168
Dakota County	19,870
Hennepin County	-3,632
Isanti County	5,024
Pierce County	2,016
Ramsey County	-17,101
Scott County	22,291
Sherburne County	13,393
St. Croix County	11,311
Washington County	13,139
Wright County	16,810

Source: US Census Bureau

Anoka County	+6.06%
Carver County	+15.81%
Chisago County	+14.27%
Dakota County	+5.46%
Hennepin County	-0.32%
Isanti County	+15.39%
Pierce County	+5.44%
Ramsey County	-3.34%
Scott County	+22.85%
Sherburne County	+19.59%
St. Croix County	+17.18%
Washington County	+6.34%
Wright County	+17.90%

Source: US Census Bureau

2001-2005 Percent Change



space. While some buyers have simply been priced out of the inner metro by cost, these particular buyers desire to live in outer metro areas because they seek a lifestyle.

On the other end of the spectrum, there has been a counter push towards urban living by segments of the population that enjoy this lifestyle. These include young-urban professionals living alone and in couples, and baby-boomers downsizing from larger houses to condos and townhomes. Both segments are seeking an active lifestyle that urban living offers, and have been drawn to the major cities of Minneapolis and St. Paul. Revitalization of both cities is a draw, if not the result, of these groups push and movement.

Twin Cities Demographics

It has been said that demographics move as slow as glaciers, but are just as powerful. This statement holds true in the Twin Cities as well. Shifting demographics are moving slowly but will have an impact in the region and furthermore the housing market.

There are essentially four segments of homebuyers by generation:

Generation Y—born 1979 or later

Generation X—born between 1965 and 1978

Baby Boomers—born between 1946 and 1964

Seniors—born before 1946

Generation X and Generation Y (Echo Boomers) will drive the future market. With these segments as buying forces in the coming years, it is time to take a new look at the market. There are differences between the segments, and younger buyers are viewing home-buying differently than previous generations.

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Resident Age Estimates

Age	Estimate
Under 20 Years	859,711
20 to 24 Years	200,545
25 to 34 Years	440,412
35 to 44 Years	515,672
45 to 54 Years	471,716
55 to 59 Years	177,462
60 to 64 Years	123,722
65 to 74 Years	152,654
75 to 84 Years	100,721
85+ Years	33,624
Median Age (Years): 35.8	

Source: American Community Survey

Residence One Year Ago

Same House	2,569,285
Different House in US	446,327
Same County	239,381
Different County	206,946
Same State	135,568
Different State	71,378
Abroad	16,790

Source: US Census Bureau

Household Characteristics

Average Household Size: 2.52
Average Family Size: 3.10

Source: US Census Bureau

Employment Status

In Labor Force	1,774,275
Employed	1,674,337
Unemployed	97,746
Armed Forces	2,192
Not in Labor Force	604,206

Source: US Census Bureau

Commuting to Work

Automobile—Alone	1,295,495
Automobile—Carpool	147,826
Public Transportation	64,322
Walked	32,659
Other Means	21,492
Worked at Home	68,733
Mean Travel Time (Minutes): 24.1	

Source: US Census Bureau

Annual Household Income

Household Income	Household Estimate
Less than \$15,000	115,030
\$15,000 to \$24,999	101,222
\$25,000 to \$34,999	112,079
\$35,000 to \$49,999	173,443
\$50,000 to \$74,999	252,981
\$75,000 to \$99,999	182,073
\$100,000 to \$149,999	180,504
\$150,000 to \$199,999	55,016
More than \$200,000	47,403

Source: US Census Bureau

Median Household Income: 59,691
Median Family Income: 73,418
Per Capita Income: 30,363

Source: US Census Bureau

According to NAHB, 26 percent of Gen-Xers and 26 percent of echo boomers intend to buy homes in the next two years, compared to 13 percent of baby boomers and 6 percent of seniors.

Research at NAHB has found that the preferences of younger buyers tend toward greater space and more sophisticated amenities than those of their forbears.

Baby boomers will also have a significant effect on the housing market as much of this segment begins to reach retirement in the next few years. Boomers are mainly existing home owners, but may be looking to downsize from larger units they currently own.

Boomers bought their current home as a place to raise a family and now are seeking smaller units with more amenities. They are living as couples without children or single people living alone. Urban living and active lifestyles will be desirable to baby boomers. They will want to move where there is entertainment close by, but also necessities such as shopping.

Demographic changes are going to be a dynamic force in the housing market in the next three decades. This is a factor that the market has not accounted for in the past, and it will be a challenge moving forward.

Twin Cities Resale Market

There is an inexorable relationship between the existing real estate market and the residential construction industry. As goes the existing market, so does homebuilding. This is due to the fact that it is a rare occurrence that a first-time homebuyer purchases a new home. Consumers of new homes are mainly move-up buyers from the existing market. Alternatively, over activity in the homebuilding industry can adversely affect the existing market. In the first half of this decade a combination of factors, both in the existing market and homebuilding, led to the eventual slowdown in 2006.

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Annual Home Sales and Prices

	Unit Sales	Average Sale Price
1998	47,836	147,346
1999	46,675	163,277
2000	48,208	181,605
2001	50,298	203,136
2002	51,212	221,275
2003	56,528	238,446
2004	58,233	256,252
2005	57,283	272,522
2006	47,906	278,462

Source: Minneapolis Area Association of REALTORS

2006 Monthly Home Sales and Prices

	Unit Sales	Average Sale Price	Median Sale Price
January	2,783	280,961	226,700
February	2,523	268,894	225,000
March	3,952	267,765	225,000
April	3,919	275,171	230,000
May	5,039	273,314	230,000
June	5,620	284,809	236,850
July	4,872	279,526	235,459
August	5,079	285,826	235,000
September	4,025	283,583	229,900
October	3,895	274,529	228,000
November	3,244	276,061	228,047
December	2,950	285,930	229,000

Source: Minneapolis Area Association of REALTORS

2006 Total Active Listings

	Total Listings
January	21,529
February	23,417
March	26,182
April	28,801
May	30,179
June	31,295
July	31,367
August	31,263
September	30,977
October	30,491
November	27,535
December	22,834

Source: Minneapolis Area Association of REALTORS

According to data from the Minneapolis Area Association of Realtors (MAAR), total unit sales peaked in 2004 in the Twin Cities, when over 58,000 units were sold. This was preceded by three straight years of over 50,000 units sold. The National Association of Realtors estimates that homeowners move once every seven years. With this in mind, it was simply unrealistic to expect that a sales pace of over 58,000 units annually was sustainable in the current metro housing market.

As sales began to slowdown, sellers continued to put homes on the market and inventory levels began to increase sharply. Further magnifying this, builders continued to add new supply through 2005. While only a portion of these units were speculative, others were purchased by move-up buyers that subsequently put their home on the market and added inventory.

Comparing some of the summer months in 2006 to the same months a year earlier shows a 40

percent increase in inventory in some cases. During the height of the traditional sales period, there were repeatedly months with over 30,000 homes available and only about 5,000 closed sales per month.

Sluggish sales and growing inventory led to a flattening of price growth in 2006. Whereas during the peak years of sales activity home prices consistently increased over six percent annually, 2006 saw no growth compared to a year ago. Towards the end of 2006, the Twin Cities real estate market seemed to slightly level off its descent. Inventory growth tapered off with a modest decline in new listings, while median sales price remained flat.

Realistically speaking, what has occurred over the past year was fully expected in this market. The sales pace and price appreciation was unsustainable, and a brief market correction is necessary to maintain the long-term stability of the Twin Cities market.

Twin Cities Building Activity

Annual Building Activity

	Permits	Permitted Units	Permit Value
1998	11,593	16,140	2,087,551,524
1999	12,157	16,996	2,309,464,223
2000	11,529	16,448	2,391,874,351
2001	10,696	16,364	2,490,481,551
2002	10,632	17,135	2,698,587,838
2003	11,472	19,000	3,100,984,175
2004	10,942	18,591	3,330,401,924
2005	10,178	18,255	3,380,265,313
2006	7,325	12,644	2,572,860,160

Source: Keystone Report

Not surprisingly, the residential real estate market is a topic of great interest recently. Everyone wants to know what the market slowdown means for the local economy, and furthermore for the industry. Lost in all of the discussion surrounding the slowdown in 2006 has been some rather good news for the industry – a transition to a buyer’s market.

Initial reaction to the transition could best be characterized as tentative among those in the

industry. Most industry professionals had reaped the benefits of a seller’s market for the first half of this decade. Builders struggled to keep up production to meet the demand and sellers could name their price. It appeared the best of times for the market.

Unfortunately, appearances can be deceiving. While demand quickly outpaced supply in the beginning of the boom, supply just as quickly outpaced demand leading into the slowdown. The frenzied market pace was unsustainable and

Multifamily Construction as a Percentage of Total Activity

2000	2001	2002	2003	2004	2005	2006
37.5	41.5	43.7	48.6	52.7	51.9	51.2

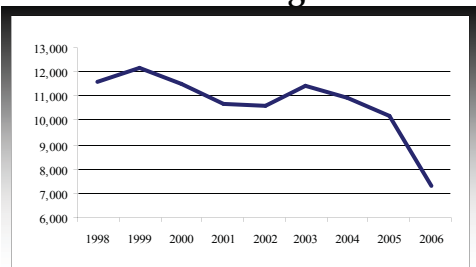
Source: Keystone Report

inventories began to build up in both the existing and new markets. Furthermore, price growth in the market had accelerated to the point that affordability started to become a real concern among many in the industry. Suddenly, builders and sellers alike were faced with escalating inventory carrying costs and products that had become unaffordable to many homebuyers. Then the market slowed down, and things began to tip in the buyer’s favor.

A buyer’s market allows everyone to step back and take a breath. Home prices can settle, inventories will draw down, and the overall market will begin to rebalance. The previous pace of both production and resale was unsustainable and threatened to harm the market even more by eliminating a number of potential homebuyers. In other words, the first part of this decade threw the market off balance in the direction of the sellers.

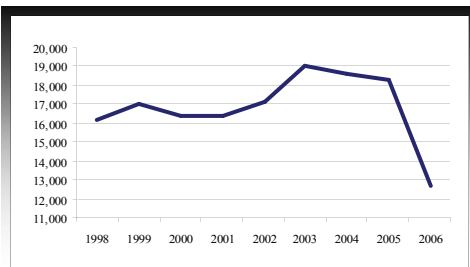
Through the first half of this decade, the residential market in the Twin Cities experienced a boom, and is now experiencing a correction. Median home price is one indicator that can be used to understand how the market accelerated through the boom. At the turn of the millennium, the median home price hovered around \$150,000 according to the Minneapolis Area Association of Realtors (MAAR). Today’s median home price is roughly \$230,000 – almost a 50 percent increase in six years. During the same time, income gains did not keep pace with price growth and the market became too inflated in parts of the region.

Annual Building Permits



Source: Keystone Report

Annual Permitted Units



Source: Keystone Report

2006: A Buyers Market

Beginning in late 2005, the market began to dramatically shift in the metro area. Inventory rose in both existing stock and new construction and price growth flattened. This brought about one of the largest changes seen in close to a decade: a shift to a buyer’s market in the Twin Cities.

Unfortunately, in the real estate market there is a lag between reality and perception. In other words, consumers do not understand that they had the upper hand. Further troubling, those that do understand were still sitting on the fence and waiting to see if the market will shift even more.

Homebuyers will drive the stabilization of this



market, but it will be a slow upward turn until the confidence returns to the point that buyers realize their opportunity. To this purpose, it’s essential to understand that, right now, a buyer’s market is one of the best things going for the Twin Cities residential construction industry.

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Twin Cities Building Activity

2006 Monthly Building Activity

	Permits	Permitted Units	Permit Value
January	613	1,000	203,036,739
February	542	872	187,184,233
March	619	955	196,851,667
April	670	1,177	223,216,758
May	769	1,052	237,280,427
June	763	1,176	264,691,133
July	636	1,047	215,034,953
August	626	1,646	255,744,115
September	417	759	163,138,877
October	455	871	180,069,028
November	492	866	178,135,497
December	479	776	176,581,901

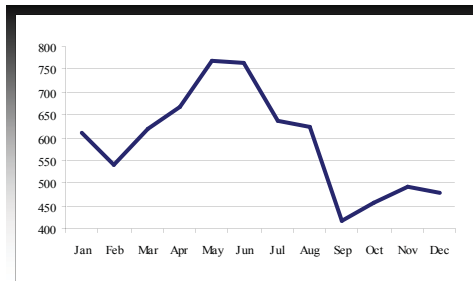
Source: Keystone Report

Dramatic price appreciation has been driven mainly by market forces, but is exacerbated by other causes as well. Restrictive land use policies have become *modus operandi* for cities seeking to limit growth due to NIMBY concerns. Home-builders and developers alike may face major obstacles such as moratoria, untimely municipal services, onerous development agreements, and excessive building fees. These policies significantly increase the cost of building, which in turn are reflected in the final sale price. In part because of such policies, it is difficult to maintain housing affordability in the Twin Cities.

Housing inventory has also added to the pressure of price in creating a market transition. Stock levels have built up not only in the existing market but in the new home market as well. Sellers lagged in response to the slowdown. They continued to place new listings and raise existing inventory. In addition, builders produced too many speculative homes and started to accumulate high levels of new housing stock. According to MAAR, there

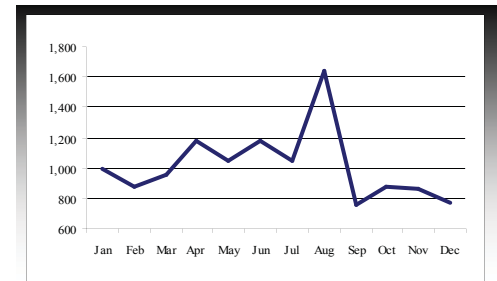
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2006 Building Permits



Source: Keystone Report

2006 Permitted Units



Source: Keystone Report

2006 Monthly Multifamily Construction as a Percentage of Total Activity

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2006
47	46	48	50	35	41	45	66	52	55	51	45	51

Source: Keystone Report

Top Cities by Annual Building Activity

Permits

1. Woodbury	394
2. Brooklyn Park	327
3. Otsego	304
4. Lakeville	272
5. Blaine	271
6. Shakopee	237
7. Maple Grove	236
8. Minneapolis	196
9. Hugo	188
10. Elk River	185

Source: Keystone Report

Units

1. Minneapolis	1,571
2. Woodbury	696
3. Lakeville	448
4. Otsego	428
5. Brooklyn Park	419
6. Blaine	403
7. Hugo	394
8. St. Paul	364
9. Maple Grove	344
10. St. Louis Park	332

Source: Keystone Report

is currently almost a six-month supply of existing stock and a nine-month supply of new stock. During the peak of the market, there was only a three to four-month supply of homes. A market is considered balanced when there is roughly a five-month supply of available homes. There will continue to be a buyer's market until supply draws down to a balanced level.

No one should be tentative about continuing a buyer's market in 2007. A continuation is what the market needs right now to help correct the problems that led to the slowdown. A buyer's market allows demand back in to soak up excessive supply. A transition also gives incentives for homebuyers to return to the market, which is – obviously – a very good thing.