

SECTOR COMMENT

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US Homebuilding

The Tariff on Canadian Lumber: Deja Vu All Over Again

On April 25, the Trump Administration announced an average 20% tariff on Canadian softwood lumber imported into the US. For decades, certain US lumber producers have complained that Canadian lumber producers were unfairly subsidized by their government and were able to "dump" Canadian lumber into the US at below-market prices. At various times in the past, there have been quotas and taxes on Canadian lumber exported into the US, but these type agreements expired in late 2015. Since the beginning of 2017, partially in anticipation of some sort of action by the Trump Administration, western Canadian softwood lumber prices (the type of lumber frequently used in home building) have risen 29%. ¹

Although final resolution on the tariff may take months, if not years, the effect on Canadian lumber producers is immediate. The impact on US homebuilders may take up to six months, since many lock in lumber prices months in advance, and will only have to reckon with higher prices when these forward contracts expire. The upshot is that all US homebuilders have already felt, or will soon feel, the impact of higher softwood lumber prices, and the additional cost impact of a 20% tariff may range from negligible (in accordance with the old Wall Street adage of 'buy on the rumor; sell on the news') to as high as 20%.

For context, imported Canadian softwood represents 28% of all softwood lumber purchased in the US, according to the National Association of Homebuilders, as reported by *The Wall Street Journal*.² The newspaper also reported that a homebuilder spends \$15,413 for softwood lumber in an average single-family home, representing about 7% of the total construction cost. Assuming everything else remains constant (which, of course, is rarely the case), a new 20% tariff would theoretically raise the price of this lumber by approximately \$863, or 5.6% ($\$15,413 \times 28\% \times 20\%$).³ Since it is unlikely that the rise in price for Canadian imports would be limited just to these imports and not affect US softwood lumber pricing, the full effect of a 20% tariff could be as much as \$3,083 per home ($\$15,413 \times 20\%$). Because a blend of both US and Canadian softwood lumber prices has already risen 20% since the beginning of 2017, it is not clear that this tariff would boost softwood lumber prices an incremental 20%.

In terms of gross margin impact on US homebuilders, our analysis shows that the effect could be as high as 110 basis points. Assuming softwood lumber prices rise an additional 20% while home prices remain constant, and assuming an initial average 20% gross margin, the table below shows the potential impact.

Exhibit 1
US Homebuilders Potential Impact

	Lumber Cost	% of construction cost	Total construction cost	Other Materials and Land Costs	Hypothetical Home Price @ initial 20% GM	Gross Profit	Gross Margin
Current situation	\$15,413	7%	\$220,186	\$204,773	\$275,232	\$55,046	20.00%
Potential 20% cost increase due to tariff	\$18,496	8%	\$223,268	\$204,773	\$275,232	\$51,964	18.9% 18.9%
Immediate cost impact due to tariff	\$3,083	1%	\$3,083	\$0	\$0	(\$3,083)	-1%

Source: Moody's Investors Service

While all homebuilders will see some effect, more likely to be adversely affected are those that build the largest homes, i.e., Toll Brothers (Ba1 stable) and The New Home Company (B3 stable).

However, the seasonally adjusted median sales price for new single-family homes in March was up by 7.2% from February and also up by 1.3% from March 2016. This indicates homebuilders still have considerable pricing power, due in large part to the paucity of supply.

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Endnotes

- 1 Eastern Canadian softwood lumber prices, also used in homebuilding, have risen at a slower rate, in the neighborhood of 20%.
- 2 This is from the 24th <https://www.wsj.com/articles/home-builders-brace-for-canadian-softwood-lumber-tariff-hit-1493086957>
- 3 The 20% tariff will be collected by US Customs and will be paid by the seller of the lumber, i.e., by the Canadian lumber producer, not by the buyer of the home. However, given the tightness of lumber markets in the past year, some or all of this tariff, if not already captured in the rising lumber prices of the past year, could result in additional price increases.

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