The MasterWerks Perspective

INFORMED OBSERVATIONS ON CURRENT HOUSING CHALLENGES AND OPPORTUNITIES • SEPTEMBER 2023

THOUGHTFUL ANALYSIS.

MEASURED ADVICE.

The Pursuit of Relevance:

The Smarter Strategy for Combating Today's Fiscal Challenges

This is the second in a series of *Perspectives* that considers the forces at work in today's economic environment and their effect on various housing activities.


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INFORMED OBSERVATIONS ON CURRENT HOUSING CHALLENGES AND OPPORTUNITIES • MARCH 2023

THOUGHTFUL ANALYSIS. MEASURED ADVICE.

The Housing Market Disconnect: Macro Forecasts versus Micro Realities

Lately, it's been hard to miss the drumbeat of news about the housing market, with plenty of doleful predictions about price declines and interest rate hikes. While the forecasts seem compelling, it's important to remember that the data behind them is general at best, typically reflecting regional or national macroeconomic trends.

The reality is that housing actually consists of micro markets. Desirability and demand vary depending on the attractiveness of specific neighborhoods and communities. Safety, schools, amenities, and services are all factors that influence housing values, in addition to market size, absorption rates, and actual inventory—not to mention the quality and appeal of individual homes and the natural human tendency to seek friends and neighbors whose interests and aspirations align with our own.

Given these factors, it makes sense to view housing markets as local. They aren't immune to larger economic issues and trends, but the effects can literally be different from one house, neighborhood, or community to the next.

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Our March 2023 Perspective, "The Housing Market Disconnect: Macro Forecasts versus Micro Realities," dealt primarily with overall market conditions and their influence on building in general.

As we previously discussed, macro-economic trends in housing must be examined through a hyper-local lens to provide any real guidance to homeowners. What the current data tells us about Edina and desirable adjacent neighborhoods can be summarized as: Lack of housing inventory is causing prices to remain high, inflation has significantly raised the costs of new construction, and interest rate hikes have aggravated the entire situation. The result is a classic inflationary spiral, causing buying, replacement, and renovation patterns to stall even in these affluent settings.

This *Perspective* addresses the use of an effective strategy—improving the relevance of existing housing—as a viable alternative to new construction. In essence, this strategy makes it possible to work with these challenging market conditions to elevate your economic outlook as well as the quality of your home environment.

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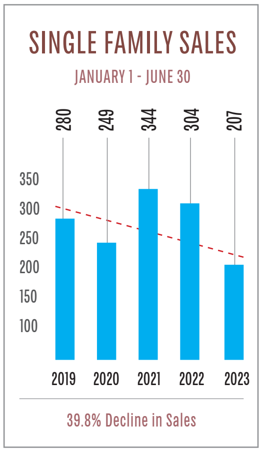
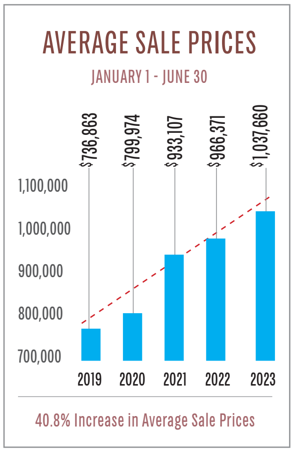
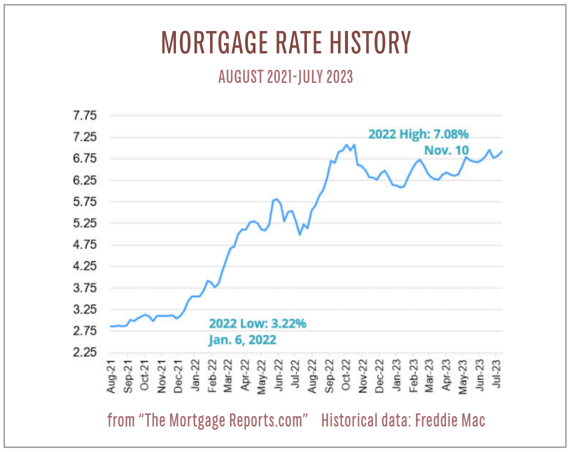
Every Crisis Provides Opportunities

Given economic forces beyond their control, we see many people who would like to make changes in their living situations descending into fiscal paralysis. Unsure what to do, they understandably do nothing, forgetting that hope is not a strategy. Although it may feel counter-intuitive, the current market does present opportunities to smart homeowners.

Despite escalating home prices and successive interest rate hikes, it's still possible to achieve investment-grade building solutions that are financially manageable in the here and now and are likely to deliver solid returns in the long run.







Here's a quick economic snapshot of past and current market conditions. The two charts at left show Edina's declining single family home sales and rising average home prices, from January through June over the past five years. The chart at right illustrates the rapid rise in interest rates that is playing an outsize role in determining those numbers and defining our current situation.

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In Season and Out: All Houses Are Depreciating Assets

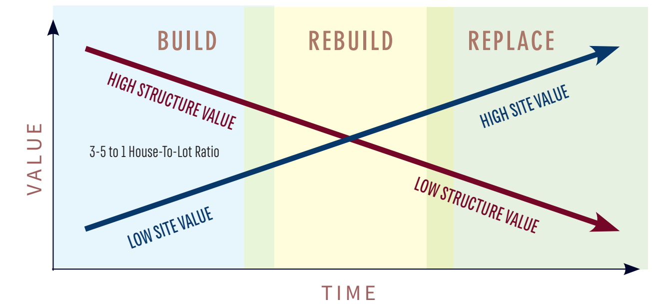
Regardless of market ups and downs, a basic fact governs home values: Every house is a fossil of its time, reflecting the lifestyle amenities, features, and utilities of its price category when first built. Time is the enemy of the structure's relevance to current or future owners since technology drives changes to various applications and equipment, and fashion drives changes to features and amenities.

Society's constant desire for the new-and-improved amplifies and speeds up that inevitable fossilization process. As time passes, the house of an earlier era becomes less desirable to upwardly mobile and successive generations of buyers.

From an investment point of view, the house is a depreciating or wasting asset, increasingly obsolete from the standpoints of fashion, function, operations, and economy. Without intervention, the structure value declines until it is ultimately eclipsed by the site value, becoming a tear down.

The opportunity for smart owners lies in arresting that wasting trajectory.

STRUCTURE VALUE DECLINES, WHILE LAND VALUE INCREASES



Useful life (50-100 years) determined by grade of construction and materials.

As a house ages, physical, functional, and economic obsolescence diminish its structure value, while its site value increases, leading to an inversion of the house-to-site value ratio. Diminishing structure value on a collective level, encompassing older desirable neighborhoods, leads to an era of transformation and replacement, called revitalization.

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The Recent Turn of the Screw: Skyrocketing Home Prices and Interest Rates

Although tear down and replacement has often been a go-to solution for clients in the past—resulting in our decades of experience in new construction and major transformations—now fewer people, even in affluent Edina, boast an income capable of covering the stiffer mortgage payments engendered by soaring new construction costs coupled with rising interest rates. The accompanying chart provides a graphic example of what people are up against. Also, homeowners who purchased or refi-ed previously, especially during the pandemic, are understandably reluctant to give up their low 2-3% rates in order to finance major building projects.

WHAT A $2 MILLION PURCHASE MEANS:

2023 purchase with interest rate of 6.73%

Down Payment & Closing Costs	$400,000 +
PITI Payments	$12,500-13,000 /month
Annual Income Needed to Qualify (depending on qualify ratios and long-term debt)	$400,000 +

The Top 1-2% Income Bracket

EDINA'S AVERAGE NEW CONSTRUCTION PRICE IS NOW $2,243,295

Only a tiny percentage of Minnesotans can afford to buy a $2M home. This cost barrier is renewing people's focus on existing homes with intensifying interest in those that are the most relevant. The best of these consistently show over-list price offers and very short market times, illustrating the viability of using a solid improvement strategy to enhance appeal and resales.

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Caught between the proverbial rock and a hard place, homeowners are frustrated by the limitations of their housing economics but feel unable to move up meaningfully. Instead, many are focusing on what can be done with older or existing properties, in some cases built as recently as the 2000s. This can be a smart strategy when informed by solid analysis and planning, but all too frequently, we see people making poor decisions out of desperation. They attack smaller remodeling projects, often undertaken and performed in a fragmented fashion, without a larger or more inclusive plan structured with appropriate attention to context or downstream return on investment (ROI).

What these homeowners fail to realize is that every project, regardless of size or scale, must be executed with an eye to elevating their home's absolute potential within its price category or tier. The market operates within price categories such as $5-$600,000, $7-$800,000, etc., but within those categories, square footage, condition, and location are the quantifiers. You can find 3,000-SF homes priced anywhere from $600,000-$1,300,000, but the trick is to elevate the $600K home to $1M or more by strategically enhancing its potential through improvements that create relevance, in some cases enabling it to compete with new construction.

In fact, new construction is the catalyst that shapes people's notions of relevance in the marketplace of ideas. By incorporating those lessons—with strategic vision, restraint, and economy, in keeping with the home's price category potential—smart owners of older homes can gain and maintain a competitive advantage.

That's why it's advisable to enhance relevance with research and great care while accommodating prevailing economic realities. This individually tailored approach effectively yields an investment-grade building solution.

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How Does a Relevant Improvement Strategy Work?

Compare How Enhanced Appeal Influences Resale Results

The examples on these pages, derived from the multiple listing service (MLS), illustrate the larger principle of price/category improvement potential. These four houses share similar neighborhood appeal, site value, and finished square footage. The differences lie in the quantity and quality of improvements in each case.

With House A, the owners made negligible updates to how the home was originally built. In contrast, the owners of Houses B, C, and especially D made encompassing improvements, enhancing livability, functionality, and overall appeal, elevating their value to various degrees. These contrasting strategies yielded drastically different sales results.

HOUSE A

$513,000
SALE PRICE

$167.05
PRICE / SQ FT

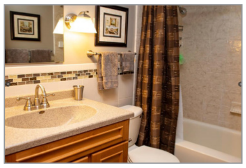
$549,900
LIST PRICE

3,071
SQUARE FOOTAGE

41 Days
MARKET TIME







HOUSE B

$853,000
SALE PRICE

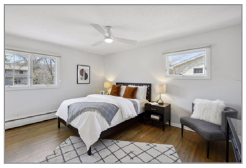
$286.15
PRICE / SQ FT

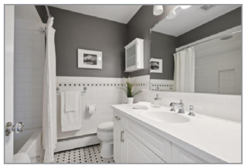
$775,000
LIST PRICE

2,981
SQUARE FOOTAGE

1 Day
MARKET TIME







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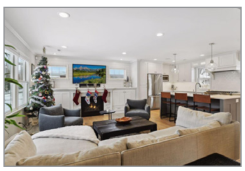
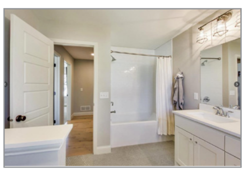


HOUSE C

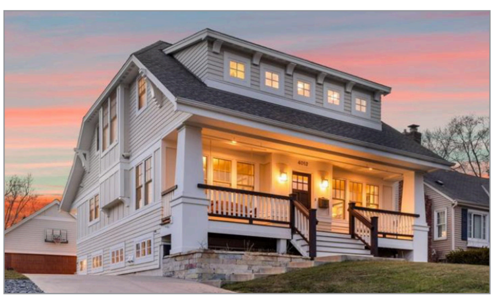
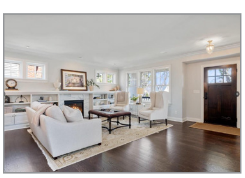
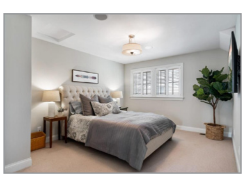
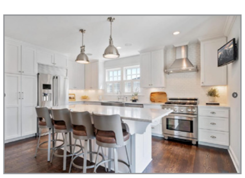
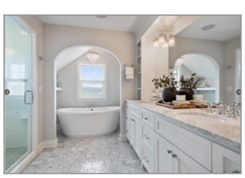
$952,000
SALE PRICE

$324.21
PRICE / SQ FT

$960,000
LIST PRICE

2,961
SQUARE FOOTAGE

12 Days
MARKET TIME

HOUSE D

$1,255,000
SALE PRICE

$416.67
PRICE / SQ FT

$1,199,900
LIST PRICE

3,012
SQUARE FOOTAGE

1 Day
MARKET TIME

House D shows the true potential of this strategy, selling for $1,255,000, a marked contrast with House A's disappointing $513,000. While Houses D and B did particularly well, achieving above-list offers after just one day on the market, House C also performed quite respectably in terms of price and turnaround time. These outcomes point to the takeaway that the better the improvements, including quality level and completeness, the greater the likelihood of return on investment.

Smart buyers recognize that a pre-owned home– made newly relevant– offers the advantages of new construction at a significantly more affordable price.

These houses and sales results were pulled from the MLS to demonstrate qualitatively different improvement strategies in the local market. They are not MasterWerks projects.

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The Time-Tested Approach: Arresting Depreciation by Enhancing Relevance

Ideally, the process of creating relevance—enhancing quality of life while delivering investment-grade potential—guides an organized process of improvement that preserves and leverages the home's economic value within its price category potential. The trick is to determine a unique strategy and related tactics that will strengthen the property's relevance and overall appeal to current and future owners, while keeping the entire process manageable from the standpoint of personal finances.

This improvement process can take various forms, depending on the client's intention, the home's physical condition and location, its overall potential for retrofitting or reconditioning, or other objectives. An investment-grade building solution should be designed to deliver improved livability and function, as well as meaningful results and returns to the owners, and in most cases must involve upgrading to compete effectively with requisite new home standards.

Homes, like books, are often judged by their covers, making exterior upgrades extremely important. This is particularly true In aspirational communities where people tend to be sensitive about the image they present, whether through clothing, cars, or curb appeal. That's why investing in smart exterior redesign may, in fact, be a more effective choice than various interior improvements–in addition to being far more affordable than many homeowners assume.

Community Revitalization is Key to Achieving Investment-Grade Building Solutions

Although not every community will repay a homeowner's revitalization efforts, Edina is a classic example of one that does. Because of its long history as a desirable inner-ring suburb, offering safety, convenience, good schools, and moderate taxes, the land is fully developed and stocked with aging mid-century homes, undergoing replacement or remodeling at a rapid pace. The well-kept, charming neighborhoods have become a magnet for upscale people— birds of a feather, flocking together, as the saying goes— who possess high incomes, equity, and a preference for newly enhanced living conditions and vibrant neighborhoods.

This mass movement of people in the private sector, working with their own money, makes Edina's revitalization process largely organic, in contrast with communities where developers are working with government subsidies. This is what gives Edina its vibrancy, while also putting it beyond the reach of many homeowners. However, even in such a well-heeled community, there are limits to how much can or should be spent on individual upgrades, depending on the home's price category and neighborhood. The balance is delicate when it comes to return on investment.

Not all communities are as ripe for revitalization as Edina for a mix of reasons. The land may be insufficiently developed and the community's housing too new and/or the infrastructure is lacking, with a combined effect that shows up in lower-quality services and schools, too much density of aging houses coupled with marginal market demand, a lower wage-earning economic base, and reduced social prestige overall. In such communities, private revitalization efforts typically haven't hit critical mass and may or may not do so in the future.

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If the potential for an investment-grade solution looks dubious, based on analytical assessment, it's best not to build or invest. Recently, we advised would-be homeowners in Eden Prairie and Chanhassen not to proceed with intended building projects. In both cases, the visions were at odds with economic reality, as the probable costs involved would eclipse the market values of competing homes in their price categories and potentially leave these couples no room to re-coup their investments at the eventual time of resale.

However, the good news is that given the right circumstances, it is usually feasible to enhance relevance while working with limitations related to finances. But it does necessitate a shift in mindset.

REVITALIZATION VIABILITY BY COMMUNITY

MUNICIPALITY	YEAR	SALES	AVERAGE SALE PRICE	PERCENT OF CHANGE	SALES 1 MILLION +	PERCENT OF TOTAL SALES	HIGHEST SALE PRICE
Minneapolis	2019	3,967	$ 333,003				
	6/30/23	1,485	391,338	17.50%	48	3.20%	$ 3,425,000
Richfield	2019	457	288,970				
	6/30/23	155	344,323	22.50%	0	0.00%	652,000
St. Louis Park	2019	627	362,750				
	6/30/23	202	457,388	26.10%	3	1.50%	1,142,500
Golden Valley	2019	326	427,845				
	6/30/23	107	560,191	30.80%	7	6.50%	2,225,000
Minnetonka	2019	630	498,094				
	6/30/23	177	677,793	36.10%	18	10.20%	3,200,000
Eden Prairie	2019	625	478,156				
	6/30/23	200	683,681	43.00%	26	13.00%	1,722,500
Edina	2019	641	736,863				
	6/30/23	207	1,037,660	40.80%	70	33.80%	4,495,000

The background map (behind the chart) shows the volume of construction projects in Edina reported through the multiple listing service (MLS) since 2005. There are many more new projects not listed with the MLS system.

CALIBRATE INVESTMENT TO EACH COMMUNITY'S POTENTIAL

Communities are not equal in their ability to support major renovation costs and provide a return on investment. It's essential to perform due diligence before you proceed and scale any improvements to fit the community—with emphasis on the specific neighborhood—profile. Any potential project must be adequately researched and supporting data verified before you commit. It's particularly important to note data concerning sales over $1 million and highest sales prices recorded, because the cost of major home improvements can be much higher than many people think, requiring more margin to recoup the investment. Evaluate with great care before investing in some of these communities.

Investment-Grade Building Solutions Require Big Picture Thinking from Homeowners

For most homeowners, it's easy to lose track of the fact that their home is the most significant investment in their portfolio with potential to appreciate. They lapse into thinking that the neighbors' growth in equity will be theirs as well, without thoughtful planning and effort. In fact, each home must be actively managed as an investment, beyond minimal, expected efforts such as putting in a new furnace, roof, or carpeting. Minor replacements like these might make a home more comfortable, desirable, or saleable than the neighbor's, but they won't deliver ROI in terms of commanding a much higher selling price.

The key to capturing and growing any home's investment potential lies in strategically managing the enhancement process, improving livability and relevance to future owners without overshooting the mark financially. As mentioned earlier, within each price per square footage category, there are sub-tiers with specific pricing that is highly sensitive depending on location and condition assessment. It's essential to gauge your home's present and future price category with precision and do enough—but not too much—to be perceived as best in class while preserving potential ROI.

For instance, putting in a new master bath might result in a higher downstream ROI, but it still depends on the larger context of the community's revitalization potential and the caliber of the individual home and neighborhood. However! If putting in that bath is warranted by analysis, it can be managed as part of a larger staged project, designed to boost the home's category, done in pre-planned steps to assist with budgetary issues. This staged approach allows clients to grow into their ultimate investment-grade solution.

Owners must use a wide-angle lens when analyzing their properties, while focusing on enhancing equity potential and merchandising the home as an asset.

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Avoid the Primrose Path to Poor "Improvements"

It's easy to get carried away with the excitement of making home improvements or creating a dream home. Just remember that the higher the price point, the bigger the risk, so it's essential to tread carefully. Bad improvement decisions can lead to disaster by forcing double project costs: once when you first build and another when you sell your home.

Common errors include misreading what the local market will bear or assuming that current trends in housing will still be in fashion a few years from now. Design choices that negatively affect the home's overall flow and appearance, idiosyncratic elements, and cost-cutting labor and materials all intersect, taking a disastrous toll on livability and future ROI. Well-heeled buyers have choices, and they will be quick discern a property's weak points.

On the opposite page are examples of properties that have failed—or are currently failing—to withstand the acid test of market realities. It's a terrible wake-up call for owners when they realize they can't recoup their investment and may, in fact, be facing a serious or catastrophic loss. Behind each of these tragically overblown "improvement" scenarios lurks a different story, but in the worst case, the owners are facing foreclosure as the mortgage is approximately $500,000 more than their current offering price.

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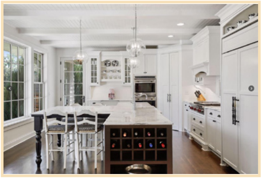
INTERLACHEN

Original List Price	$4,200,000
Current List Price	$2,900,000
Market Time	791 Days
Status	For Sale



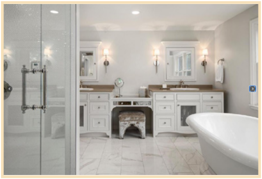




SUNNYSIDE

Original List Price	$3.500,000
Current List Price	$2,395,000
Market Time	224 Days
Status	Closed







CIRCLE WEST

Original List Price	$2,750,000
Current List Price	$1,900,000
Market Time	442 Days
Status	For Sale

These Edina houses and sales results were pulled from the MLS to demonstrate various problems that are costing the owners dearly. They are not MasterWerks projects.

Proven, Relevance-Enhancing Strategies Set the Stage for ROI

Once you're convinced that building makes sense strategically—improving livability, serving life goals, fitting with the neighborhood context, and strengthening long-term fiscal wellbeing—you're ready to begin the planning process. Regardless of the project's size or scale, all upgrades should be thoughtfully planned with an eye to becoming best-in-class within the anticipated higher price category, with a payback when the time comes to sell.

We suggest clients think in terms of economic value per square foot, not simply price per square foot, a critical distinction. There are major factors like design, materials, and workmanship that can add initial costs to a project but far surpass corner-cut, price-driven, lower-cost options in terms of livability and overall appeal, which can radically improve downstream ROI. The truism tends to hold true: You get what you pay for. The danger, however, when it comes to construction, is that you sometimes get much less than that. Most of this work is done in "aspirational" communities where overall appearance and curb appeal matter. Beauty is in the eye of the beholder, but there are generally preferred standards and predictable patterns.

In most cases, strategic updates to older properties tend to heighten their relevance for clients and future owners, making these existing homes more attractive and valuable for those who can't or won't purchase new, given the rising costs of new construction, higher interest rates, and in some cases, increasing awareness of environmental impact. Since the number of people who can truly afford new construction is statistically smaller, we are seeing buyers focused on finding fully relevant or best-in-class homes with price-appropriate features and benefits, which can be purchased for considerably less.

Circling back to the issues of skyrocketing home prices and interest rates, today's buyers are generally uninterested in homes that need substantial work, because they don't have additional time or money to invest in making more upgrades once they've closed. That's why sellers who haven't managed their homes as an investment, strategically enhancing relevance, often incur significant losses when they put their homes on the market, as illustrated in prior Perspectives.

As mentioned earlier, the quest for relevance also applies to newer homes built since the 2000s, as well as older properties. Driven by lifestyle choices, we see an active segment of our clients choosing to improve their homes in the manageable, thoughtfully staged process that we're advocating. Typically, this takes the form of smaller, segmented projects such as kitchen; baths; minor upgrades to counters, cabinetry, and trim; porches and other elements.

When upgrades appear seamless, as if originally built that way, they maintain the home's integrity, strengthening competitive advantage at the point of resale. No matter what the project is, by upholding a timeless aesthetic, steering clear of trends, and adhering to high quality standards, owners can preserve relevance for years to come. They avoid the acute loss of value and painful disillusionment that occur when once-trendy fashion homes fall out of favor or when poorly designed and executed projects are actually exposed by the harsh reality of the marketplace and its judgments.

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Relevance from the Inside Out

The owners of these homes selected MasterWerks to upgrade kitchen, bath, and adjacent areas to more elegant design standards. The improvements eliminated the deficiencies they were experiencing, as well as various out-of-date, trend-driven design choices. The seamless upgrades better meet the owners' current needs, while raising the overall level of relevance to future buyers when the time comes to sell.

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MN RES BUILDING CONTRACTOR LICENSE NUMBER BC643121

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Never Underestimate the Power of Exterior Transformations

As previously noted, exterior upgrades are pivotal to value enhancement and are ultimately the fastest way to improving ROI. These before-and-after photos demonstrate the power of this principle, with stunning outcomes. Their resounding visual impact quickly translates to a much higher perceived value by those who view them—even before they step inside.

MasterWerks transformed the exterior of these two homes, elevating their appeal and value.

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Resale Numbers Prove the Success of Our Investment-Grade Building Solutions

Over time, the pursuit of relevance has become the critical tool—essentially our compass—for determining how to quantify, judge, and apply housing strategies and tactics. We've tracked results for decades in terms of studying our client's resale results when they put their strategically enhanced homes on the market. After factoring their investment dollars, inflation, and comparative price per square foot (Price/SqFt), these clients have earned substantial profits, outpacing other comparable houses in their respective price categories.

Clearly, even in a fast-changing economy, relevance-driven strategies are producing highly desirable, best-in-class homes that out-perform the competition. The outcomes manifest not only in sale prices that deliver solid ROI for our clients but in short market times and multiple offers.

Although new construction and transformations will always rank among our essential services, there is no question that today's economic forces are sharpening the focus on relevant, used housing stock. Increasingly, clients are turning to us for investment-grade building solutions, delivered within a manageably staged plan, executed with trademark versatility and expertise.

MasterWerks Homes:

SOLD for 23.6% MORE Per Square Foot	Were 12.6% SMALLER with Finer Finishes	And Sold in 42.1% SHORTER Time on the Market

To our knowledge, no other builder tracks or publishes their resale records. As this chart demonstrates, MasterWerks clients (the sellers) reaped the advantages of our comprehensive approach, reselling to buyers who paid a premium for high-caliber design, functionality, and quality.

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Timing is Key: Mine the Silver Lining

While we all wish we could avoid periods of economic hardship in the housing market, there are rewards for coming to grips with reality versus languishing in financial paralysis.

To summarize, the best current strategy for smart homeowners is to pursue relevant, investment-grade building solutions, staged in ways that are financially manageable. By being proactive now, you will improve your lifestyle while optimizing the fiscal gap that exists between new construction and used homes in price categories more affordable to would-be buyers.

What doesn't pay is playing a wait-and-see game. Inevitably, an economic event will trigger all the procrastinators to come off the sidelines, causing prices to rise further due to demand and increasing labor shortages. Now is the best time to deal with costs that won't decrease—and which you may be able to refinance, if or when rates drop.

In short, carpe diem: Seize the initiative, zig while others zag, and capture the outcome.

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