

From Big Builder May 2010

Posted on: May 10, 2010

Feature: Nowhere to Go But Up

Private builders are finding ways to buy time until the housing crash is far enough behind for banks to lend again.

By Sarah and Teresa Burney

For Jerry Wade, president of Artistic Homes in New Mexico, dealing with banks these days is the stuff of nightmares. “You just want to tell them they can go kiss the south end of an elephant going north,” he says.

The problems started when the bank he'd dealt with for more than 20 years joined the ranks of the more than 200 banks the Federal Deposit Insurance Corp. has taken over since the sub-prime mortgage crisis sent the American financial industry into a tailspin. Since then, he's been looking for a new source of financing—with little luck.

He says it's hardly worth hitting up other banks, as he knows “a lot of builders who can't build a damn pre-sold home.” The banks have little appetite for vertical financing and even less for horizontal. For the moment, he gets by thanks to a private investor who has been buying land for him.

“In 1984, '85, things were bad,” Wade says. “But it's nothing like what we've got going on now. It's just ridiculous.”

Wade's grumblings are a common refrain among the private builder set these days. For as much as private builder executives are business managers, many of them are also business owners who've poured their hearts, souls, and savings into growing their business in the best of times and keeping them alive in the worst of times—of which the past three years most definitely qualify.

However, patches of blue have begun to appear in what's otherwise a dark and cloudy sky for home building. New-home demand has a pulse again, home prices have stabilized, and land remains a bargain. Normally, those are signals that it's time, after years of atrophy, to begin to rebuild a future, one where success means more than just keeping the lights on.

But the banks aren't biting. In fact, they continue to pull back on lending in the sector, further curbing their exposure to the home building industry until asset valuations find a firmer floor. According to information from Zelman & Associates, banks reduced acquisition, development, and construction (AD&C) lending by 23 percent last year and are on track to pare that down another 26 percent in 2010.

Still, many privates have to replenish community counts to spark cash flow from sales; others need to access lower-priced land to balance their portfolios and rebuild profitability. Without access to capital, many private builders are finding not only their recovery but their survival once again threatened.

“The recovery has started, and if we can't build homes, why did we tough it out?” asks John Wieland, founder of namesake John Wieland Homes & Neighborhoods. “Why did I put all this personal money into the company? The answer is, I did it to get to the upturn, and now, if we can't enjoy the upturn, it looks like I made a big mistake.”

PUBLIC OPTIONS

At the same time that private builders find themselves manacled by capital constraints, their public builder counterparts are having few of the same issues.

Collectively, the publics raked in roughly \$2 billion in tax refunds from Congress' extension of the net operating loss tax carryback provision. Moreover, the publics have successfully tapped the public markets, raising additional equity and buying back debt for premiums of cents on the dollar.

And without the encumbrances of financing provisions like secured debt, personal guarantees, subdivision bonds, and the like, public builders are becoming tougher competition for the private guys. “The current situation is giving public builders tremendous advantage and market share,” says Bill Hoover, who leads operations for Las Vegas-based Adaven Homes.

And the publics are hardly being shy when it comes to deploying those capital resources. In fact, many are aggressively pursuing finished-lot land deals and are reported to be gobbling up lots as fast as banks can spit them out through the REO process. This feeding frenzy, which is going far in recalibrating land values, also is beginning to drive prices north.

“The publics pay 2.5 times what we'd pay,” says Scott Shapiro, CFO for Florida-based Highland Homes. “I don't know how they are doing it ... but they can do it because they pay cash.”

What's left for private builders are carrion—20-lot deals, scattered lots, and other “screwball lots,” says Hoover. “You can't build a business on that,” he says.

LOTS NEEDED

Privates have had to dig deep, get creative, and turn to relationships for an edge. Land owners and developers sometimes accommodate this group's constraints, signing over lots to builders but agreeing to wait for payment until the homes built on the lots are closed.

Similarly, bank fee-building deals allow private builders to build without paying for lots. But for as much as the fee structure means revenue, it's not a sustainable business model. It might temporarily serve to pay their bills, but there's not much left after overhead.

So, sweetheart developer deals and fee-building only go so far. Firms need not only to reload with lower-priced land but also do so with enough scale to capture efficiencies if they plan to partake in the next up cycle.

It's hard to see how. Despite fears over the future of community banks, a few financially surefooted ones are stepping up to fill the financing void left by big commercial banks. Builders are going to see higher rates on the capital—prime-plus versus LIBOR-plus—but many see it as the last best option.

Of course, making that option a reality is easier said than done

As finished lot supplies dwindle in desirable “A” and “B” locations, private builders have to be thinking about either acquiring new land that needs improvement or sinking money into developing existing assets. Either way, the prospect of tapping traditional financing sources for A&D funding is bleak. What difficult is to vertical financing, nearly hopeless is to horizontal financing.

“Land debt is virtually nonexistent as far as banks are concerned,” says finance consultant Tony Avila with Avila Advisors.

SEEKING PRIVATE INVESTORS

But, in real estate, where there's a will there's often an investor.

With traditional lending sources reluctant to stick more than a toe into the water, private builders are ferreting out investors of all shapes and sizes—from local high-net worth individuals and land sellers and developers to subs and materials suppliers.

“We've gone to all of those sources and put together three or four of those deals,” says Fieldstone Communities president Chad Ogden.

More and more, big private equity dollars play a role in private builders' capital conundrums, which according to Avila, can work as a timely match of need and solution.

Many private equity sources are hot for residential real estate. They've invested little in the space over the past two to three years, Avila says, and see home price stability, a pickup in order pace, and low asset values as indicators that it's a good time to begin deploying capital. Private equity often also is more open to A&D investment, which aligns with what observers identify as a private builder core competency: land development.

“Land in and of itself is a private business,” says UBS housing analyst David Goldberg.

The way Goldberg sees it, turnover on land is too long to comfortably fit the public builder model. Builders often have to hold assets for a number of years to get the returns they want, which is at odds with the public's need to report to stockholders quarterly.

However, generating private equity interest is one thing; extracting a commitment is another. What private builders often have to come to terms with is that private equity doesn't tend to do entity-level or “blind pool” investments, says Avila. Rather, they're keener on project-specific financing, so private builders have to learn to approach them with a particular land parcel in mind or, better yet, land that is already under control.

Also important, private equity has its own measuring tape when it comes to sizing up a potential investment candidate. Although both private equity and private builder would agree that low leverage—Avila says no more than a 2:1 ratio of debt to capital—and profit-ability are high on the list of “musts,” operational skills such as absorptions, quality, warranty, efficiency, and cycle time don't rank as critically as financial metrics.

“The financial investor will care about those things,” says Avila. “But they really want to know how that impacts the internal rate of return and equity multiple.”

PRIVATE ADVANTAGE

Capital access is a mighty concern, but few private builders are apt to turn turtle merely because the public holds an upper hand.

Mike Moody, president of Newmark Homes Houston, says that although the public's edge means they will take market share in the near term, he believes the public lacks the capacity to serve the needs of all home buyers.

And because there are segments underserved by the public, private builders can succeed.

“Capital—just capital—isn't going to define a public builder's success, especially in places like Houston,” Moody says. “It takes a lot more than capital.”

The “more” that Moody is talking about are precisely the things on which private builders have long staked their reputations—the ability to make decisions faster, run leaner, operate more profitably, have better local relationships, and know customers more intimately. By leveraging these competencies, private builders intend to outflank their public builder brethren rather than outmuscle them.

“The public has the advantage,” Adaven's Hoover says. “But as they continue to build and go through inventory, we're going to use them as drafting in the NASCAR sense—they're going to pull us along.”

IN THE NICHE OF TIME

For as much as privates may be losing the market share war these days, they are winning key local battles.

Moody, for example, says he just inked a deal on some bank-owned lots because his company's small corporate structure allowed management to close more quickly. A public builder may have taken longer to reach a decision, as most land transactions have to be evaluated at the corporate level, Moody says.

Rick Dalton, president and CEO of the Jacksonville, Fla.-based start-up Wellington Homes, says having little overhead has allowed the company to diversify its business to gain access to new revenue streams that in turn help to stopgap some of the company's financing issues. Not only is the company dabbling in the remodeling market, in some cases helping banks rehab REO properties, but it's also started doing water, smoke, and fire remediation work on behalf of some insurance companies.

"Today, it's about attitude," he says. "It's a street fight out there."

But where many private builders say they see the most success is in finding a product niche that's distinct from the bulk of what's on the market.

In some cases that means building "greener" or more energy efficient than the big publics. In others, it means developing smaller-lot or infill communities. Other builders are differentiating themselves by offering more "value" to buyers through larger square footages, upgraded finishes, or custom changes to floor plans or elevations. And still others are leveraging special financing or credit programs to attract more credit-challenged buyers, who require more touch to prepare for homeownership.

IN TIME, BETTER CONDITIONS

For as smart and strategic as many of these financial and operational tactics may be in today's market, they no doubt fall short of delivering the volume that many private builders grew accustomed to during building's halcyon days. And for a good number of privates laboring under legacy land and debt, that could mean the end of business as they've known it.

However, for other privates, these maneuvers are enough to help them eke out a living. And as long as they can at least break even, they buy themselves some time.

Time, they hope, will be the salve that the capital markets need to take some of the sting out of some of the deep real estate-related losses that they suffered as housing's decline intensified. Once lost confidence in the sector is restored, there stands to be a significant shift in the market.

Currently home building's hand is tipped heavily toward the public builders, with their well-fortified balance sheets and cash-lined coffers. But once capital constraints loosen and money starts flowing toward home

building's private players, their competitive edges, temporarily dulled, will once again be honed to razor fineness.

"These are opportunistic people, so they'll hang around the rim and wait for something to happen," says UBS' Goldberg.