

Private Angst

As banks deleverage real estate debt, private builders get squeezed out.

“Companies with fewer than 500 employees helped lead the economy out of the last four recessions ... But this time, almost six months after the U.S. economy began growing again, small businesses continue to cut capital spending and dismiss workers,” reports Michael McKee (*Business Week*, Feb. 22, 2010). “Lack of access to credit also affects small businesses disproportionately. The Federal Reserve reported on Feb. 1 that banks were continuing to tighten standards for loans to small businesses, while standards for large companies were unchanged.”

Connect the dots—small businesses equal private home builders. The fuel for home builders is credit, and that’s in short supply. Zelman & Associates reports: “Outstanding AD&C loans totaled \$509 billion as of 4Q09, down 25 percent year over year in absolute terms, the largest contraction of any major loan category and in line with our estimate.”

For any company, a 25 percent reduction in business resources is harsh. For builders, it may be the difference between staying in business or not—or the difference between making money or not.

The NAHB forecasts an increase in single-family starts to 560,000 in 2010, from 444,000 in 2009, up 26 percent. That jump will come as good news, but it will favor publics with access to capital over privates with limited or no capital.

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»Home building’s business models have different risks. The “NVR” manufacturing model has the lowest. Developing land has greater risk, and acquiring and entitling raw land has the greatest risk. Lenders will demand to be paid for their risk. Expect higher fees and interest rates on land acquisition loans and the highest fees and interest rates on land held for development.

»Banks have alternative investment opportunities other than lending

to builders. Given the risk associated with residential construction, the return demanded by banks on construction loans simply must be higher to compensate for the risk.

»As lenders cut risk by constraining loan-to-value and loan-to-cost ratios, builders get more of the risk. But most builders don’t have the cash to fund these higher requirements.

»In the absence of loan syndications, the size of loans made to builders will shrink. Banks have limits on loans to one borrower.

»Lenders are only willing to service their current builders to improve their position on existing loans.

»Personal guarantees are back with a vengeance. In today’s environment, lenders want an additional source of repayment, plain and simple.

An outcome we anticipate from the stressed lending environment private builders face is acquisition activity. Privates will be desperate to salvage some equity, and publics will spot an opportunity to gain market share at accretive prices.

Until credit flows to small businesses, the engine of recovery will sputter. Banks must lend to home builders in order to drive economic growth for the benefit of all. **BB**

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