

# Credit Envy

*Private builders pay to climb the wall of risk as publics' access to low-cost debt widens.*

A paradigm shift has split home building into a tale of two cities. Thomas Kuhn's "The Structure of Scientific Revolution" introduced the notion of "paradigm shift" in 1962. Advancement is not evolutionary, Kuhn asserts. It happens via a "series of peaceful interludes punctuated by intellectually violent revolutions."

For private home builders, the violent revolution is in the capital markets. The industry is sharply polarized by ownership boundaries. Public builders gain market share thanks to abundant cash reserves and low-cost public debt; private builders lever cash reserve pittances in efforts to arrange bank debt.

Public builders finance long-term land assets with long-term debt, matching up the durations, returns, and due dates. They have strengthened their balance sheets with abundant cash reserves and increased their capacity to raise even more capital.

Private builders have failed to match durations. They invested in long-term land assets and financed them with short-term bank debt. As the 12- to 24-month durations of the debts expire, they can't convert the assets to cash fast enough. If the lender is unable to extend financing on similar terms, default is inevitable. The result is a weakened cash position with little additional debt capacity.

The capital markets have rallied around the publics.

The risk premium on public builder debt has fallen significantly. The risk premium is the result of subtracting an individual builder's (or the weighted average of a group of builders) current yield on its debt from the current yield of a Treasury with a similar duration. The risk premium is the difference between the cost of risk-free debt (Treasury) and the cost of debt that has risk, such as a builder's debt.

Home builder public debt is yielding about 6.5 percent, down from 17.1 percent in December. Assuming an average duration of builder debt of 10 years, the 10-year Treasury is yielding 3.7 percent as of March, implying a risk premium of 280 basis points. Investors are requiring a return of 280 basis points to assume the risk associated with investing in public home builder debt; that's especially good in these times.

You'd expect the cost of private builder debt to shrink in tandem with the cost of public builder debt. Why? Three factors contribute to a company's cost of capital: the risk-free rate of borrowing for similar durations, the risk premium associated with the industry, and the risk premium associated with the riskiness of a particular company. So, as industry risk moderated, the spread between the yield on both public and private builder debt ought to have moderated similarly.

Not only have the yields not moderated, but publics can raise capital even while the flow of debt to privates tightens. Our conclusion: A paradigm shift is underway as lenders view the mismatch of duration and the increased riskiness of private builders' balance sheets warily and, consequently, price this risk into the spread between public and private home builder debt.

A wider spread in the cost of debt decreases private builders' ability to compete and forces them to innovate to compensate for this paradigm shift. Conversely, publics, like a wind shift in yachting, need to capitalize on the advantage by not allowing their competition back in the race. **BB**

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**Yield to Maturity:** Public Builder Bonds vs. 10-Year Treasuries

