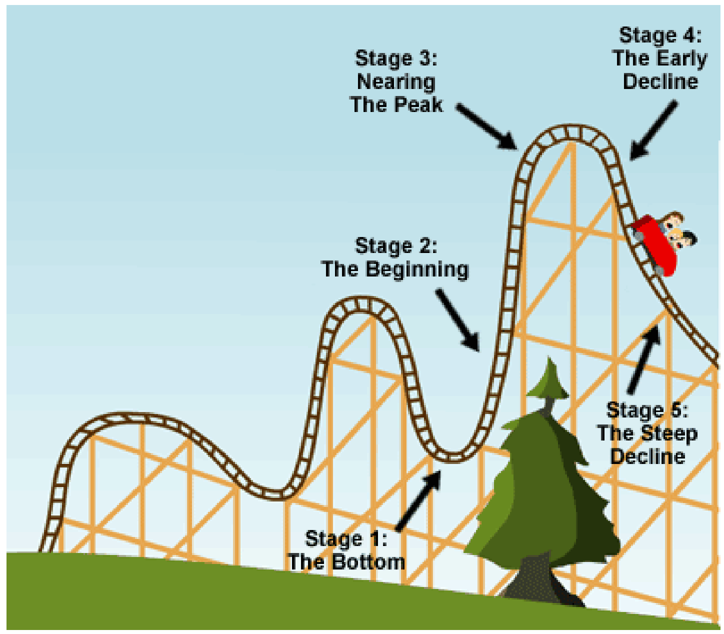
"A Strategy to Navigate the Housing Cycle"

By: John Burns
John Burns Real Estate Consulting

The housing cycle is usually long and has 5 major stages, which are shown below. I began consulting to real estate executives' right before a downturn that began in 1990 and ended in 1995. The subsequent expansion lasted 10 years. After 18 years of observing this cycle and studying past cycles, here is the best general advice I can muster for managing in the cyclical home building business.

Stage 1: The Bottom

Finance Strategy: Cash is king. If public, consider taking yourself private. Start a new company if you can.
Land Developer Strategy: At the bottom, we suggest that you make long-term land investments by buying large assets with cash. Consider buying on the peripheral areas at steep discounts and with your own money so that debt and equity service is not a factor. This is a contrarian view, which is why it is a good view. Opportunity funds want 2-5 year returns and will be buying land in better locations. We suggest being very aggressive here, and avoid generating significant short-term expenses such as interest payments or option payments. In most downturns, you can buy fully entitled land from the banks at less than the cost of the improvements that are already in place. If you are like most and can't bear to think beyond 5 years, don't plan on making much money from market appreciation.



Home Builder Strategy: If you bought land in an outlying area, sit back and wait for the market expansion to head your direction. Focus your home building efforts on good locations, and on perfecting an operating company that is efficient and profitable without the benefit of price appreciation. Value-oriented detached homes sell best.
Debt and Equity Strategy: Lend and invest aggressively. The downside is limited and most of your competitors will be still questioning the business after the losses they just sustained.

Stage 2: The Beginning

Finance Strategy: At the beginning of the up cycle, secure long-term financing that won't mature anytime soon. Throughout the up cycle, continue to push financing maturities out and use multiple sources of capital, from multiple industries (banks, pension funds, offshore, etc.). Don't pay the expenses associated with land banking or option payments unless you are truly so efficient that you can make a great return while doing so.
Land Developer Strategy: Buy land in the next cities that will become the great locations as the market expands. Continue making the long-term land investments discussed above. Underwrite aggressively if needed because your downside is limited. Raise money from diversified companies with long-term horizons, such as pension funds and insurance companies.
Home Builder Strategy: Put some cash back into the business to improve efficiency, and begin pulling some cash out of the business to diversify your investments and improve liquidity. Grow your business slowly with an emphasis on diversifying into new geographies or product types. Hire the right people and structure their compensation to align their incentives with yours over the very long-term.
Debt and Equity Strategy: Keep lending and investing aggressively.

Stage 3: Nearing the Peak

Finance Strategy: Consider selling your company because growth-oriented firms tend to overpay for land and companies during this part of the cycle. You might also want to pay yourself a lot of money by going public, although you will certainly create a lot of expenses and headaches if you choose that route. If you are not a seller, stick others with the downside risk by using joint ventures or off-balance-sheet financing. JV capital will be plentiful. Restructure all of your lots to be based on rolling option takedowns. This expense might cost 12% - 15% per year, which is why we recommend this strategy at this stage of the cycle rather than throughout the cycle. Refinance with more expensive non-recourse debt.

Land Developer Strategy: At this stage, the risk is highest and so is the short-term return. In this last cycle, "Stage 3: Nearing the Peak" lasted for years. You never know for sure when the end of an expansion will occur. Implement an "Asset Light" strategy where you only own the land you need to fund operations, but have plenty of options with well-capitalized land developers and partners so you won't run out of land during a downturn. Concentrate on locations where there are fewer home builders. Shed any high-density attached projects because the builder demand will be high today, but the consumer demand will be low tomorrow.
Home Builder Strategy: Put even more money into process efficiency. Build more cost-effectively than your competitors. Avoid mid-rise and high-rise construction unless you are experienced at it and underwrite it with the additional risk it deserves. Avoid land development for the same reasons.
Debt and Equity Strategy: Sell or syndicate your investments to other institutions. Syndications or participations are a great way to maintain your builder and developer relationships while reducing your risk. Consider a hedging strategy that will be expensive but will be worth it if the market corrects.

Stage 4: The Early Decline

Finance Strategy: Look around. Are competitive levels and/or affordability levels worse than usual? If so, you can count on the downturn being prolonged. Pay down your short-term debt obligations and build up cash reserves by selling your homes and land as quickly as possible, even at a loss, because the loss will be greater later. Many believe that losing money is somehow a sign of failure and disastrous to the balance sheet. They are wrong. This is a cyclical business. Recovering as much of the cash that you have already spent is what matters. Hire a great tax advisor too.
Land Developer Strategy: Sell your land. Early on, there will be plenty of optimists willing to buy it from you at a perceived discount. Cultivate your banking relationships, because they will be the land sellers of the future.
Home Builder Strategy: Develop a site-specific strategy to generate cash. This will not be possible at some communities, which should be halted. As one CEO executive told me, "The downturns are always longer and more painful than people think they will be."
Debt and Equity Strategy: Sell your worst loans to other banks. Use renegotiations due to covenant violations to reduce your exposure. Keep a small percentage of the debt to your favorite clients. Staff your Special Assets Department early with experienced building industry executives - not just bankers - and incent them to act quickly. Raise some money for the future, but don't spend it.

Stage 5: The Steep Decline

We believe we just began Stage 5.
Finance Strategy: All of your preparation should have paid off. While this isn't fun for you, it is worse for others. Pay off all of the debt you are obligated to pay.
Land Developer Strategy: Advise the banks. Help them decide what to do.
Home Builder Strategy: Build homes for troubled banks and equity partners in a structure that provides them most of the upside and, more importantly, protects you from any downside.
Debt and Equity Strategy: Take your lumps. Demand all that you deserve, but don't push your borrower into bankruptcy. If you do, the lawyers will get rich and customers won't buy their homes or lots. Hire outside expertise to provide independent analysis to the loan syndication group because you'll rarely be able to reach consensus. Once you see stability in the market, buy back the loans from the other banks and start planning your expansion strategy.

Conclusion

Many of the smartest companies in our business, which are run by veterans of several housing cycles, have implemented many of the strategies above. The majority of the smaller and younger companies in our business have not. All builders, however, wish they had done more off-balance-sheet or option agreements and sold more land. 2008 is going to be a very difficult year, but you will learn more than you have ever learned and you will emerge a smarter and better company (or perhaps even a new company). The demand for housing will continue to trend upward for the rest of your life, but there will be significant bumps along the way. Managing through the bumps is the challenge, and those who do it deserve the greatest recognitions and rewards.

John Burns Real Estate Consulting *helps their clients determine strategies make decisions and monitor real estate market conditions. Our Building Market Intelligence™ consulting process helps bring clarity to the decision-making process.*

John Burns Real Estate Consulting
Headquarters: 4000 Barranca Pkwy, Ste 250, Irvine, CA 92604
Office (949) 262-3228 Fax (949) 262-3226 www.realestateconsulting.com
Additional locations: San Diego, Sacramento, New England