

Effects of the Credit Crunch on the Homebuilding Industry

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While the wave of bankruptcy filings and closures of mortgage brokers has had a severely negative impact on the nation's economy, the effect of that credit crunch on the homebuilding industry may ultimately have ramifications that will run deeper than the effects felt in the mortgage industry. With very few exceptions, such as San Antonio, Texas, which is currently a very good housing market, the housing industry throughout the United States is in significant trouble.

As reported by one research analyst, we are in the midst of a 20% decline in the sale prices of resale homes. That is the greatest decline since the Great Depression. (www.housingpredictor.com/crisis.html, March 4, 2008).

Throughout California, applications for new building permits are significantly lower than in the prior year. In Sacramento, one of the more troubled areas in California, new building permits were down about 66% from January 2007 to January 2008.

In Los Angeles, in December 2007, 26% of the resale houses that were sold had been purchased at the peak of the market (7/05-12/06) and, of those, 58% were sold at prices below the mortgage amount. In Orange County, 27% of the houses sold in December 2007 were purchased during the peak period and, of those, 63% were sold at prices below the mortgage amount. The figures for San Diego County were 21% purchased during the peak period and 64% sold below the mortgage amount, and for the Inland Empire 35% were purchased during the peak period and 77% sold below the mortgage amount.

It is an astounding statistic that in the Inland Empire, over one-third of the houses sold in December 2007 were purchased during the peak period and over three-fourths of those were sold for a price less than the amount of the mortgage.

Most single-family home developers are sustaining very substantial losses, and to generate cash some of these developers have begun selling houses at 20% discounts, far below the builder's costs. While sales at deep discounts might provide a mechanism to solve short-term cash flow problems, ultimately many of these builders will go out of business if the current trend continues.

The collateral effects of the single-family home malaise are significant. One of the most obvious effects will be the decreased revenue from real estate taxes received by cities and counties.

In November 2007, a report authored by the U.S. Conference of Mayors predicted that the housing recession will reduce property values in 2009 by \$1.2 trillion and slash tax revenue by more than \$6.6 billion. (www.bloomberg.com/apps/news?pid=home, March 24, 2008). Some counties in California have adopted automatic programs to begin reassessment of properties and to reduce the assessed values, and, as a result, real estate tax income, of single family homes in hard hit areas. Tax assessors offices in most counties are overflowing with requests by home owners for reassessment. The long-term effect on schools and other projects funded by real estate taxes of this reassessment and reduction has yet to be felt, but it is almost certain to occur.

In addition, there are added costs to municipalities as a result of houses not being occupied and lawns not being maintained, as well as related expenses that will increase as the number of foreclosures and vacancies increases.

Even non-profit cultural institutions are being adversely affected by the housing crisis. As reported in the Friday, March 21, 2008, issue of the Los Angeles Times, "some of Southern California's major cultural institutions are bleeding because of the sub-prime mortgage crisis, with combined losses of more than \$3,000,000 - and mounting – since February when their seemingly safe and innocuous construction bonds turned into fiscal leeches." (Los Angeles Times, March 21, 2008, Section E, page 1). "Among the non-profits that are scrambling to escape interest payments that have more then doubled are the Los Angeles County Museum of Art, The Orange County Performing Arts Center and the Natural History Museum of Los Angeles County and the Colburn School." (*Id.*)

The interest payments have increased for the non-profits due to fears that as a result of the huge financial losses suffered by the insurers of sub-prime mortgages, those insurers may no longer be financially answerable on their policies insuring repayment of bonds issued by the non-profit institutions. Thus the policies that gave the bonds issued by the non-profit entities their high ratings, and therefore lower interests rates, are no longer being viewed as an absolute source of secondary recovery by the financial community.

Not surprisingly, the mortgage and housing crises are affecting the poor to a disproportionately greater degree than they are the wealthy. Social services departments indicate

that the homeless rates are on the rise, not only from families that lose their own homes, but from renters who have been evicted following foreclosure of their rental unit. (www.msnbc.msn.com/id/22246203/).

Foreclosures also negatively impact the value of other houses in the same neighborhood. According to a study conducted by Georgia Tech Associate Professor Dan Immergluck concerning foreclosures in Chicago in the late 1990s, "each foreclosure on an urban block lowered property values by an average of nearly 1 percent, and about 1.4 percent in low income neighborhoods" (www.msnbc.com/id/23599085/).

While intuitively one might think that a slowing of the sales volume of houses would benefit those in the remodeling industry, as reported in the San Diego Union Tribune on February 24, 2008, that is not the case. Rather, the housing downturn has actually significantly slowed the remodeling market.

The downsizing by builders has significantly added to the number of vacancies in the commercial rental markets in Southern California, and the effect of these layoffs, together with the layoffs being experienced in related trades, such as sub-contractors, has contributed significantly to the number of unemployed people in California. It now appears that the originally published job growth figures for California in 2007 were substantially overstated, (with the job growth for the Inland Empire, Riverside and San Bernardino counties), being revised from an increase of 42,300 jobs added to just 1,100 added in 2007. Projections for 2008 range from minimal job growth to an actual loss in the number of jobs.

An intangible effect of the housing and sub-prime mortgage crises is the effect on consumer confidence that the continued press coverage of these crises creates. According to Federal Reserve Chairman Ben Bernanke, "there is something on the order of 4 cents or 9 cents on the dollar of an effect on consumer spending when home values decline." (www.reuters.com/article/bondsnews/idUSWAT00789620070719, July 19, 2007)

The engine that drives the U.S. economy is consumer spending. A lack of consumer confidence, if it results in significantly decreased consumer spending, will significantly dampen the U.S. economy, further driving down prices of houses and increasing significantly the losses to be suffered from sub-prime and alt A mortgages.

For builders who own raw land inventory or lots in the process of entitlement, or even fully entitled lots, the situation is much more dire. While builders with finished houses can

obtain cash by selling the houses at deep discounts (even if at a loss), the situation is not the same with respect to raw land and lots. Most builders owning raw land inventory or lots are in covenant default with respect to their loans (*i.e.*, they are in breach of provisions in their loan documents, such as having a minimum net worth or debt to equity ratio), which gives lenders the right to cease funding on their loans.

As the housing crisis deepens, and the value of houses, as well as land and lots upon which houses would be built, continues to decline, lenders have been increasingly reluctant to continue funding builders to take lots to full entitlement.

In addition, lenders have begun the process of reappraising the lot projects and, when the appraisals come in significantly lower than the original appraised value of the projects, making a demand upon developers to re-margin their loans so that if a loan was originally made at 70% loan-to-value, the developer would be required to pay down the loan to a point that the loan amount would be 70% of the new appraised value. For most cash strapped developers in this market, funding their projects through entitlement from their own funds, or making re-margin payments, is either not possible, or not advisable.

For public builders, and private builders with substantial cash reserves, there is no realistic alternative to making the re-margin payments and fund the lot projects to entitlement from their own funds. As a result, these demands represent an increasingly large, and unrealistic, cash demand in a declining market.

There are very few buyers for raw land or lots at prices that would make any sense to the developers. While there are billions of dollars in funds which have been assembled to take advantage of the depressed real estate market, to date there have been very few actual purchases of lots.

The perception in the market place is that the value of raw land and lots will continue to decline. Under such circumstances, it makes financial sense for the distressed real estate funds to delay purchasing land or lots. This is so both because the funds will likely be able to purchase the same inventory later at a lower price and because the period of time that they will be required to carry those lots until the market turns and the lots are saleable at a profit will be shorter.

Lot values have decreased to the point that many raw land and entitled lot projects actually have a negative residual value (*i.e.*, the cost to complete the lots is greater than the amount that the lots can be sold for upon completion and entitlement). Based upon the offers

being made in the market place today, lots are being valued at a percentage of the actual dollars which have been spent for improvement and/or entitlement, with no value being attributed to the underlying land.

On the bright side, governmental agencies have recognized the seriousness of the problems in the sub-prime, alt A and homebuilding markets, and are making attempts to mitigate the problems in those markets.

Recent legislation has resulted in an increase in the maximum loan limits for mortgages which can be purchased by Fannie Mae. In addition, the Federal Reserve has recently increased the funds it will make available and broadened the collateral it will accept beyond the highest rated mortgages in order to pump more liquidity into financial markets. The recent decrease in the Federal Funds rate, the assistance from the government in the proposed purchase of Bear Sterns by JP Morgan Chase, and the legislation signed by the President to stimulate the economy by making direct payments to many tax payers from the government all indicate a clear governmental recognition of, and willingness to attempt to mitigate the damages created by, the sub-prime crisis and the housing crisis.

In addition, builders have been seeking from local governmental entities delays in the payment of developmental impact fees. Currently, builders are required to pay those fees at the time building permits are issued. Builders are asking for a delay in the obligation to make those payments until the house is ready to be occupied. The response of governmental entities to such requests, especially when the decrease in real estate tax revenue will squeeze the financial condition of those entities, has yet to be determined.

Two home builders, JMC Homes of Roseville and Lennar Corporation, are offering properties with 30-year fixed-rate mortgages with 4.875%. To put this rate in context, the average rate of 30-year fixed-rate mortgages has not fallen below 5.23% in Freddie Mac's 37-year history.

In addition, KB Homes is selling houses with a guarantee that if either the price of the house, or the interest rate on the loan obtained to purchase the house, falls prior to the closing, the buyer will be entitled to either the lower purchase price or interest rate.

The National Association of Homebuilders has suggested that a tax credit of \$10,000 be given to anyone who purchases a newly built house. While at first the proposal may appear extreme, it is interesting to note that the Tax Reduction Act of 1975 gave people who bought a

new home in that year a tax credit equal to 5% of the purchase price, up to \$2,000. In 1975, the median home price was around \$39,300; it was about \$246,000 in 2007, according to census data. (San Francisco Chronicle, February 28, 2008.)

The Foreclosure Prevention Act of 2008, which has been introduced in the Senate, contains a variety of measures to assist homebuilders and improve the housing market. One of the most significant provisions of the Foreclosure Prevention Act of 2008 would allow homebuilders to get tax refunds by applying losses incurred between 2006 and 2008 to taxes paid on profits for the past five years, instead of the two years allowable under the present law.

The transaction between Lennar Homes and Morgan Stanley which occurred at the end of 2007 was to a large extent a transaction driven by the ability of Lennar to carry back the tax loss created by the transaction to 2005, and to receive a very large refund of taxes paid in 2005. If developers are allowed to carry back losses for five years, the cash benefit to developers from income tax refunds may be substantial.

It is not yet known whether these responses to the housing crisis and the sub-prime mortgage crisis will have a significant effect on affected markets.

While it is impossible in such turbulent financial times to predict the future with regard to either the sub-prime mortgage, Alt A mortgage or home building markets, there are several negative factors that have not yet occurred (or which have occurred but will be continuing) that will negatively impact these markets.

The first of these factors is that the sub-prime and Alt A loans will continue to reset as to interest rates and monthly payments in the months to come.

An estimated 5 million adjustable rate loans will reset by the end of 2009. (www.housingpredictor, March 24, 2009).

The number of U.S. homes that were involved in some stage of foreclosure in 2007 was 79% higher than in the previous year. ([//biz.yahoo.com/ap/080129/foreclosure_rates.html](http://biz.yahoo.com/ap/080129/foreclosure_rates.html).)

In January 2008, monthly foreclosures exceeded the number of monthly home sales in California. 19,821 homes went into foreclosure in January in California representing about \$8 billion in loans. (Mercury News, February 23, 2009).

Nationally, February 2008 "marked the 26th consecutive month with a national year over year increase in foreclosure - related filings." (www.msnbc.msn.com/id/23601813, March 13, 2008).

The sub-prime mortgage crisis and housing crisis have even affected the value of conventionally financed houses. In 2007, the prices of conventionally financed homes in the United States declined for the first time on record. (Toledoblade.com/apps/pbcs.dll/article?aide/20080227/business06/802270384, February 28,2008).

The typical time period in California between the first defaulted payment on a loan and the time the property securing repayment of loan becomes property of the lender is about ten months. Thus, defaults that currently exist, and defaults which can be predicted due to reset interest rates and payments in the months to come, virtually assure a continuing increase in the number of single-family residence foreclosures. As those foreclosure rates continue to rise, and perhaps even accelerate, the negative impact on the housing market, both for resales and for developers attempting to sell new houses, is obvious.

In addition, to date, lenders have primarily attempted to sell houses that have been foreclosed upon at market sales prices. As the number of homes being held by lenders dramatically increases, as it inevitably will over the next six months, and assuming lenders act as they have in the past, lenders will sell houses at greatly reduced prices, thus further depressing sales prices in the single-family home market.

A related but significant additional problem is the consequence of lenders foreclosing upon raw land or lot projects. Lenders typically do not like holding such collateral, and in this market it is very possible that lenders will sell raw land or lot projects at greatly depressed prices. Thus, when the market begins to improve and new construction is commenced, the developers who were able to avoid foreclosure of their raw land and/or lot projects will have a basis in that land, or those lots, that will make it virtually impossible for them to compete with other developers who purchased land or lots from the lenders at greatly reduced prices.

The impact of these two factors (wholesaling of single-family homes and of lot projects by lenders) will most likely have the same effect on real estate values and prices as the action of the RTC in the early 1990s when it sold portfolios of loans and or properties at greatly discounted prices, thus further depressing the real estate market, causing other savings and loans to fail and to repeat the process.

An additional negative factor in this market, which does not bode well for the future prospects for developers, is the fact that the bankruptcy laws, which, since the real estate crisis of the early 1990s, have been subject to legislative changes which do not favor debtors and have

been judicially interpreted recently in ways that are detrimental to debtors, do not seem to provide much protection for developers and/or home builders who are forced to file bankruptcy. Under the relevant provisions of chapter 11 of the Bankruptcy Code, the debtor must either have a substantial equity position to protect the secured creditor, must be able to operate a profit after filing a chapter 11, or must make the regular debt service payments to the lender during the case, in order to remain in a chapter 11 case and prevent the secured lender from foreclosing on its collateral. For many developers and homebuilders with troubled projects, none of these three conditions can be met. In addition, in 2005, the Bankruptcy Code was amended to define "single asset real estate" as follows:

real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental. 11 USC § 101(51B)

Under Bankruptcy Code Section 362(d)(3), a creditor is authorized to seek to obtain relief from the "automatic stay" in any Chapter 11 case filed by a "single asset real estate" debtor unless the Debtor-in-Possession has complied with one of two statutory alternatives within 90 days following the entry of an order for relief. Thus, a creditor will be able to successfully obtain relief from the automatic stay otherwise imposed under Section 362 if the "single asset real estate" debtor fails within such 90-day period to either:

- (i) file "a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time"; or
- (ii) commence *monthly* payments "in an amount equal to interest at the then applicable non-default contract rate of interest on the value of the . . ." secured claim held by the moving party.

The provisions described above were added by the amendments to what is now the Bankruptcy Code enacted into law on October 17, 2005. Although the prior version of the Bankruptcy Code had contained a similar provision impacting "single asset real estate" debtors, the prior statute did not apply if the debts in the case under Title 11 exceeded \$4 million. Under the current Code, the \$4 million "cap" has been eliminated in its entirety.

To the extent that real estate companies have filed chapter 11s, the filing is typically made by the holding company with the purpose of dealing with unsecured debt issues at that level and to protect the proceeds from the projects owned by the developer with a positive value.

For the smaller real estate developer, the individual owning the development company is typically required to sign personal guarantees of the secured loans made to the entities owning the projects. The issue thus becomes one of preserving the individual guarantor's net worth in the face of large deficiencies at the project level which translates into personal liability based on the guarantees. The prospects for the individuals under those circumstances are often bleak.