



Course Correct

Why risk losing your credit facility?

Here's a plan to endure re-cap limbo.

Capital—both credit and equity—is now a crisis for home builders. Home building is heavily dependent on capital, both to fund the massive investment needed to construct homes and to achieve acceptable levels of risk-adjusted returns.

What can builders do to survive amidst a capital crisis? The answer—easy to say and hard to do—is that builders must strengthen their balance sheets.

Like many banking and mortgage lending institutions, builders would like to strengthen their balance sheets by attracting money from outside investors. Through recapitalization, builders could reduce leverage and increase their available cash. Recapitalization takes one of two forms: an investment in the existing company or an investment in a new company, commonly referred to as “Newco.” Given the significant deterioration of builders’ financial positions and balance sheets, investors tend to shy away from investing in the existing operations for an obvious reason—the fear of throwing good money after bad.

Investors are interested in sourcing specific distressed assets and finding a well-established management team with a proven track record of success. While this approach may open up future opportunities, it does nothing for a builder’s existing operations and the financial problems faced.

The second major challenge is that while a significant amount of noise suggests private equity has an interest in investing in residential real estate, very few deals have actually been completed.

After talking with dozens of private

equity firms, my key takeaway is that private equity sources are eager to invest in distressed assets, but they are reluctant to pull the trigger until a bottom has been achieved. Until such time as a bottom is recognized, private equity will wait.

So how can companies strengthen their balance sheets, minus outside investment?

The first critical focus should be on securing one’s existing credit facility. To do so, home builders need to strengthen their balance sheets. Amid the disarray in the credit markets, new credit facilities will not be easy to

a walk is as good as a hit. Balance sheets can improve by reducing debt as easily as by earnings. When earnings are in short supply, lenders will respond positively to builders who pay down debt consistently.

Moreover, builders must streamline operations to reduce losses, which hurt the balance sheet. Every excess must be eliminated. Decisions about people, facilities, and procedures must take Pareto’s Law into account. Italian economist Vilfredo Pareto realized most benefits come from a minority of effort. His theorem is known as the 80-20 rule. Builders need to be disciplined; they



- ✓ **Reduce existing debt.** As you move product to reduce debt, leverage will improve.
- ✓ **Reassess profit motives.** Price homes aggressively; selling at cost can still reduce debt.
- ✓ **Streamline operations.** Follow the 80-20 rule: You can only afford undertaking 20 percent of the effort to deliver 80 percent of the benefit.
- ✓ **Hire the best, and pay them accordingly.** It’s a must when doing more with less.

come by. Most lenders want to downsize exposure, not increase it.

Builders must sell, build, and close homes so existing debt can be reduced. As debt is reduced—assuming equity on the balance sheet is not reduced—leverage will improve, strengthening the company’s balance sheet.

While builders strive to earn a profit on the sale of every home, the goal now is different. Debt and leverage can be reduced even if a home is sold at cost. Price homes aggressively to move through inventory and repay debt.

A side benefit of such a tactic is the message it sends to lenders. In today’s market, lenders want to see debt being repaid on a consistent basis. In baseball,

can only afford to undertake 20 percent of the effort delivering 80 percent of the benefit.

Finally, if the best people are not in your position, builders are risking their ability to survive. We have to get the best people we can find, and we have to pay them that way. We can’t carry along people we don’t need; and we need to have better people if we are going to get more productivity from fewer of them.

Continued access to capital depends on a strong balance sheet; builders need to work every day to strengthen theirs. **BB**

Jamie M. Pirrello is the CEO of Fort Myers, Fla.-based Vision Homes USA and the CFO of Michael Sivage Homes and Communities. He may be reached by e-mail at jamiampirrello@msn.com.