Professional Builder

Change is in the Wind

Whether we are weathering a minor blip in home sales (like 2001) or the major housing market downturn many analysts have long expected (like 1991), only time will tell. Whichever it is, it's already profoundly affecting the home building company merger and acquisition marketplace.

Michael P. Kahn

April 01, 2006

Several years from now when we look back at late 2005, it will be interesting to see whether the transition that began in November in housing markets — and the value of home building companies — looks more like 2001 or 1991. Whether we are weathering a minor blip in home sales (like 2001) or the major housing market downturn many analysts have long expected (like 1991), only time will tell. But whichever it is, it's already profoundly affecting the merger and acquisition marketplace where home building companies are bought and sold.

A Level of Uncertainty

Housing industry consolidation will not stop. The big public builders will still need to grow, and acquisitions remain one way to accomplish that. Whether public or not, large builders with the bulk of their operations in challenged markets (like most of the Midwest) will feel more pressure than ever to diversify geographically by opening shop where sales are still strong. Acquisition of a local builder with a strong management team and established trade relationships remains the least risky way to penetrate a new market. So deals will still happen, but there's a level of uncertainty about where housing is heading that makes it difficult to know what companies are worth. What price is the right price?

Public builder P/E ratios have decreased from their recent highs. No builder will do a dilutive transaction. A deal has to be accretive, and to make that happen, we see a reduction in the amount of cash buyers will pay to sellers at closing. Buyers are looking at the future earnings sellers bring to the party. Future prospects are as important as the past history of earnings, but buyers today will cast a critical eye toward backlogs and projections of "hockey stick" growth curves.

"Nobody minds paying for growth after the fact," one buyer told me. "But if a builder says he's going from 300 units in one market in 2005 to 500 in 2006, even if the lot supply is in place and the management team is strong, in times like these, you have to question if they're really going to hit that number. If their market is heading down, can they *sell* those extra 200 houses?"

What you'll see is more deals with reduced cash paid to the seller at closing, and increased focus on earnouts to provide incentive to local management to deliver real growth.

Shrinking Goodwill

Goodwill in acquisitions will become an even harder sell, especially among public builders. Stock market analysts are reluctant to put a stamp of approval on any deal with a large amount of goodwill. During the M&A frenzy of recent years, buyers were willing to do deals with large amounts of goodwill attached, even if they couldn't find a creative way to deal with it. They would take their lumps from analysts to add a new market or enhance a predictable and stable earnings stream. But today, buyers are beginning to say they might not be willing to do that. As the balance of power shifts their way, look for buyers to seek more control over terms — not just price and how much money is shifted from the front end of the deal toward the back, but also soft terms like treatment of goodwill and tax allocation.

Trends that began in 2005 (or even earlier) that will carry over into this year include an increasing number of buyers looking for deals, especially if they perceive a movement toward a buyer's market. The public builders have huge war chests of cash, much of it allocated for acquisitions. Many of them are so flush with cash that they are building out of pocket rather than using their vast lines of credit. Once they have a feel for the shape of sales curves over the next few years, they will be in the M&A market in force.

Acquisitive builders often run like a herd; they rush to whatever market looks hot. Atlanta could be next. Geographically, Florida, Arizona, California and Las Vegas seem likely to continue as the hottest targets for new market penetrations. Washington, D.C. may continue to be hot, but flip to a buyer's market as affordability becomes a greater issue.

Density Reigns

The hot product is likely to remain anything built to densities above five units to the acre. Last year, the public builders even began moving into high-rise condo product. The danger there is that condo apartment buildings are subject to the same tendencies toward over-building that have plagued the rental apartment sector for decades. Already, Las Vegas and Miami seem headed in that direction. But builders specializing in infill mid-rise condos, fee-simple townhouses and high-density detached homes will be highly prized acquisition targets, especially if they build in the land-challenged major urban markets.

Metrics

Another trend that emerged in 2005 that will only increase in importance this year is the ascendance of *return on assets* as a metric to judge the desirability of an acquisition. Earnings are still important, but sellers who learn to option a greater percentage of their land inventories, and are willing to structure a sales transaction so that land assets are held back — then funneled to the building company over time — will have a better chance of getting a deal done. Both of those strategies produce a higher return on assets, making the selling company more attractive to buyers, especially the public builders.

Author Information

Michael P. Kahn is president of MPKA, a financial advisory firm specializing in housing industry mergers, acquisitions and capital formation.