

Stephen Kim's thoughts on leverage, land value, and loose credit in the recovery



There's a sentiment that because the tight supply for labor and land constrains home builders from building as many houses as demand warrants, the economic downturn, when it comes, will be a mild one. Stephen Kim isn't one to say the sky is falling, but the senior managing director for Evercore ISI's Building and Builder Product Equity Research isn't so sanguine about the ride through the next recession being a soft one. He notes that publicly traded home builders are more land-leveraged than they were just before the Great Recession. Also, the notion that loan defaults during the next downturn wouldn't be as severe because credit is tighter this time could be a fallacy, considering that the percentage of homeowners who bought houses in affordable price ranges with less than a 5 percent down payment is greater now than in 2005. Kim has more observations about the current recovery cycle and the impact of tax reform on land value.

Q You noted that the top public builders haven't become asset-light compared with where they were regarding land ownership and options before the recession. What's your take on land spending as a percentage of revenue?

A Essentially, what we have observed is that builders have been talking a lot about becoming more land-light, but their actions speak louder than their words. A couple of things I would note are that if you look at the amount of land builders own today relative to prior periods, you would actually see that builders own more land than they did in prior cycles, not less. What's also interesting is that the amount they spend as a percentage of their revenue has actually been increasing. After falling from the unsustainable heights they reached in 2012 and 2013, those land-spend levels, as a percentage of revenue, came back last year to the industry average. But now they've actually started to nose back up again.

My point is that if you're making a call that the builders are substantially more asset-light, you have two main problems: One is that they're not more land-light, they're more land-heavy than they were, and secondly, they're not spending less, they're spending more. It's like when you're on a diet; if you want to lose weight, you have to eat less. Well, the builders here, if they want to get the ownership down, they have to buy less, and they're not doing that. That was the one-two punch that we were seeing on the land side.

Q Does it make a difference if builders control the land but they don't actually own it?

A It would if it led you to a different conclusion than what we arrived at. One of the things we'd heard was that builders were saying that they are optioning land. They were saying

they're land-light. But they are actually land-heavy.

In particular, one of the things we've heard is, "Oh, the builders want to option 50 percent of their lots." We said, "All right. That's great. Let's take a look at history." What you find is that throughout almost the entirety of the mid-1990s to the mid-2000s—the latter half of the last cycle—optioning 50 percent of lots was totally the norm. There's nothing unusual about optioning half of your lots. You would absolutely not say that makes this industry different from what it was in the past. It doesn't.

The second thing we point out is that it doesn't really matter what percentage of your lots you option. What matters is how much land you own. So let's say you option 90 percent of your lots, but you own 10 years. Does the fact that you have a 90 percent option ratio make you less land-heavy? No, you own 10 years of land. It's the wrong metric to begin with. But even if you look at the metric, you would see that there's nothing special about it.

Q Would that lead you to say that the industry hasn't learned its lesson?

A I think it's worse. It's not that builders don't see the risk inherent in owning land. It's that they don't have a choice. One of the things builders will readily admit is that, unlike in the previous cycle, there isn't a large stable of land developers that have the ability to hold land for builders.

For the complete interview with Stephen Kim, see probuilder.com/skim