

ECONOMIC INSIGHT

Real Estate Plunge Tests Survival Skills *Builders Trim Size and Expenses to Stay Afloat*

By Meagan Hardcastle

Southeast Michigan land developers and builders struggling to pilot out of a prolonged tailspin don't see a break yet in the economic clouds. So residential and commercial property companies are cutting payrolls and projects to survive.

This region's real estate market is reeling from a sudden blow - the residential sector seemed to fall out of the sky last year after reaching an all-time peak in sales volume and prices during early 2005. Real estate markets around the nation are enduring downturns, and while some are starting to see a brighter horizon, Michigan's recovery likely will lag behind the pack.

As employment falls, so does demand for housing and all types of commercial space - leaving developers, builders and landlords with bloated inventories and sharply reduced revenue. A widespread cash crisis among residential real estate companies is one result of Michigan's jobless rate -- which reached 7.2 percent this summer, the highest nationwide. Southeast Michigan unemployment was 7.7 percent.

Forces battering developers also include a weak local economy, lack of consumer confidence, population loss, rising interest rates and

decreasing mortgage availability due to credit tightening provoked partly by a flood of foreclosures.

The result is a landscape as bleak as veteran builders have ever seen. New housing starts in Southeast Michigan plunged from nearly 30,000 in 2004 to 12,000 in 2006 and just 1,500 in this year's first quarter, according to data collected by MarketGraphics Research Group. If that 2007 pace continues, Metro Detroit's housing construction will be only 20 percent of what it was three years ago. "The Southeast Michigan market has hit bottom," concludes Jeff Steidle, president of MarketGraphics. "We anticipate that the market will continue to run along the bottom and do not see any firming up until the fall of 2008 to early 2009."

Market Imbalance

As often happens with industry nosedives, few anticipated or responded in time to the severity of the situation. Land development and home building continued at a bullish pace well into the downturn, burdening firms with excess inventories. As of May 2007, MarketGraphics Southeast Michigan inventory statistics showed 147,000 developed and undeveloped lots, plus 6,000 homes under



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construction and another 6,000 that were finished and unoccupied. Looking ahead, the data-tracking firm forecasts demand for fewer than 12,000 homes annually through 2010.

That severe supply-demand imbalance explains why developers and builders can't necessarily attract buyers even with deep discounts. Auctions to liquidate excess inventory sometimes fail to generate even minimum bids.

In this brutal environment, even a national player feels pain and shows strain. Pulte Homes of Bloomfield Hills lost \$593 million during the first half of 2007 and has had three rounds of layoffs since 2006.

One bright spot comes from sales of existing homes, which have risen steadily since January, says the Realcomp II Ltd. multiple-listing service of Farmington Hills. "While these numbers continue to be about 7 percent below those from 2006, they do indicate that sales are picking up with each successive month," CEO Karen Kage writes in Realcomp's July 2007 report.

In the commercial sector, 21 percent of Metro Detroit office space – 14.4 million square feet – was empty at midyear, according to Grubb & Ellis Co. Even Novi, a previously hot location, had a vacancy rate above 18 percent as the third quarter began. Things could get worse this year, warns the latest Grubb & Ellis research report.

The same economic factors affect construction and leasing of retail and industrial properties.

Navigating the Crisis

O'Keefe consultants help companies survive during the downturn by identifying overhead cost reductions, negotiating relief from trade creditors, restructuring loans, and maintaining lenders' confidence – all strategies to conserve limited capital and continue operating. As turnaround consultants in Michigan, we typically have a high concentration of manufacturing-related clients. Now, however, assignments increasingly involve developers, builders and their bankers.

Widespread illiquidity among even the most successful local developers and builders presents a very unpleasant scenario for bankers, as they face the painful likelihood of massive real estate

loan charge-offs in the upcoming year. But industry veterans have seen this before, and it's only a matter of time before the market recovers. The question is when. The current local recession and housing market decline are reminiscent of the recessions in the early 1980s and early 1990s. Both previous recessions were characterized locally by automotive industry distress, high unemployment rates, and a steep drop in residential building. Both recessions had a negative impact on housing activity for four to five year periods.

Statistics collected by the Southeast Michigan Council of Governments show that building permits sharply declined from a peak in 1978 to a low in 1982, rebounded to another peak in 1986 and then fell sharply again to a low in 1991. Over the next 13 years, permits increased at a fairly steady rate, peaking again in 2004-05. Nationally, permits began falling off in 2006, while Michigan's decline began a bit earlier, with permits falling dramatically in 2005. If history repeats itself, the local market will start to recover in 2009-2010.

Encouraging Sign

A healthy market is characterized by roughly equivalent supply and demand. With the current oversupply of homes and lots, we await a substantial increase in demand for housing -- which will be driven by a stronger economy and higher employment rates. Auto industry restructuring and the state's ability to attract new business are critical.

The recent Chrysler transaction is encouraging – Cerberus Capital

Management is a very sharp investor with the turnaround experience, intellectual horsepower and financial resources necessary to make Chrysler efficient and profitable. The other auto makers will be forced to keep up. While this will be great for our local economy over the long term, the fundamental changes needed to achieve success will be painful in the short term.

Whatever the industry, distressed companies must conserve cash and stretch resources to stay afloat. For real estate companies, a secure comeback ultimately depends on stronger employment, affordable mortgage rates and consumer confidence in the region's economy.

But no formula or forecast can reliably determine how long Southeast Michigan builders must hang on – or which ones will still be here to welcome an economic recovery.

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