Lending to Single Family Residential Builders and Developers

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Truist

Commercial real estate lending is the art of making an informed judgment about the character and experience of the sponsor, and the science of understanding the durability of Borrower cash flow and collateral value.

This is a science course!

Lending to Single Family Residential Builders

Understanding the Market and Project

There is no substitute for the lender visiting the site, observing the surrounding area, and inspecting the the project!

Lots of growth nearby…

The view of the hills is beautiful…

The US Residential Market

Historic seasonality, cycles commonly begin with a stall

Builders who failed to manage their liquidity cushions, expenses and inventory failed in last cycle - super regional and national builders now dominate

Elevated Pandemic demand was supported by low mortgage rates

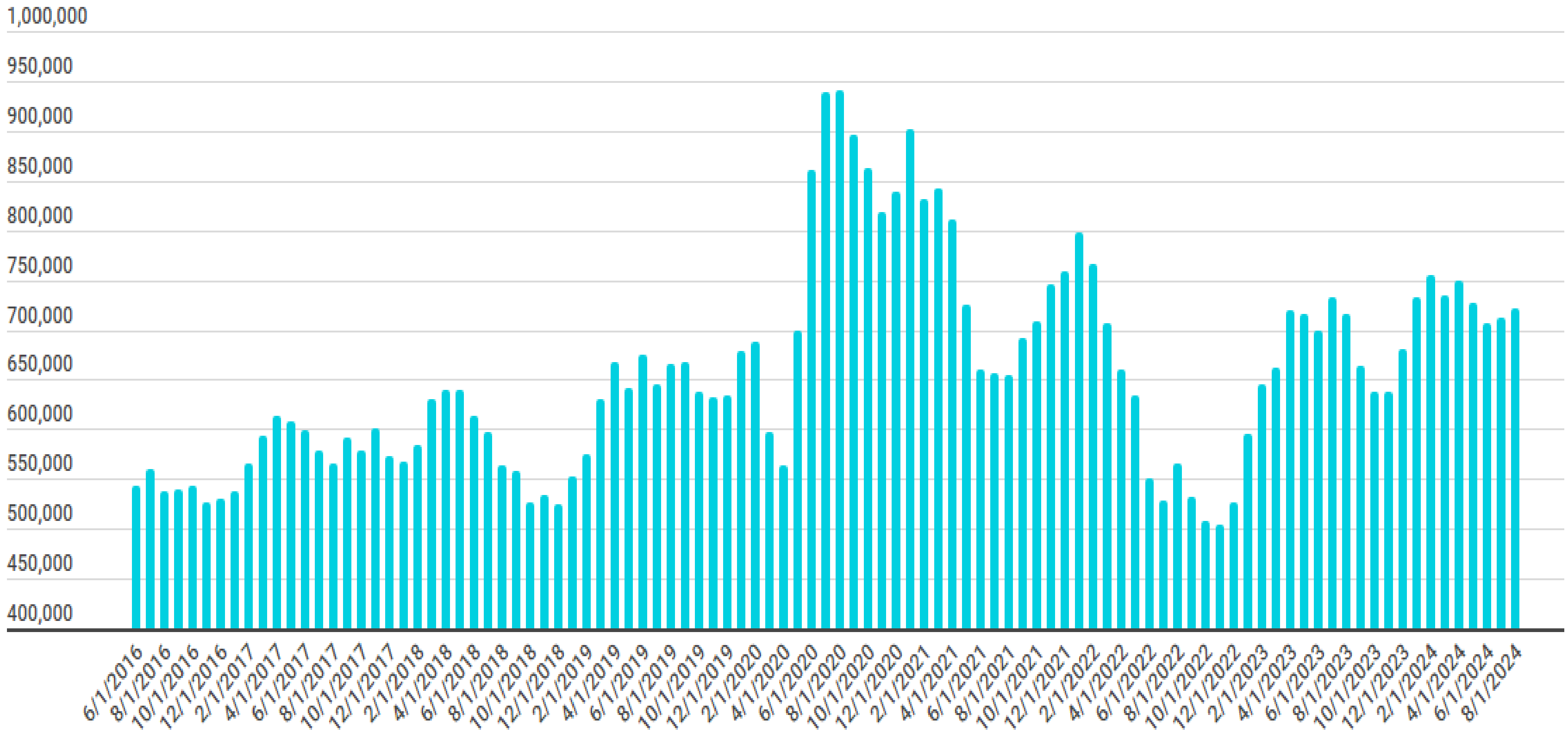
Low existing inventory – existing owners unwilling to sell

Builders benefit – strong margins = ability to offer incentives

Buyer affordability challenges persist, rising interest rates may dampen demand

Declining pricing in select price points and locales

New Home Sales (SAAR)



Residential Property Types

Detached:	Traditional single family residential dwelling unit on an individual lot.
Attached:	Physically connected dwelling units, such as townhomes or condominium units, typically governed by an Association.
Manufactured:	Commonly refers to Detached units constructed in a manufacturing facility, and assembled onsite.
A&D:	Residential Land Acquisition and Lot Development.
BFR/BTR:	Purpose-built single family residential units that are Rented, and operated together as a single Project, akin to Multifamily, as opposed to units being Sold to individual unit buyers.

Residential Property Classes

Starter:	Smaller dwelling units priced to appeal to first-time home buyers, typically those earning at or less than the Area Median Income.
1st Move-Up:	Larger units with better quality finishes, typically priced to appeal to buyers earning at or above AMI, and within conventional loan limits.
2nd Move-Up:	Larger units with high quality finishes, typically priced to appeal to buyers earning well above AMI, and may require a jumbo mortgage. Indistinguishable from Luxury in some cases.
Luxury:	Dwelling units with very high quality finishes, typically located in high income locales, and priced within the top 10% of listings in a market.
Ultra-Luxury:	Dwelling units with custom designs and finishes, typically located in very high income locales, and priced within the top 1% of listings.

Construction / Completion Risk

The risk that the project will not be completed according to plans and specifications.

There may be unforeseen circumstances that interfere with the project, causing delays that will increase the construction costs, even though the market value of the project may not increase. Or, the completion problems may be attributed to poor planning and project management.

In either case, the lender is left with a project that either cannot be completed at all or that, when completed with modifications or cost overruns, will not have a value sufficient to support the financing amount.

Construction risk can apply to loans secured by income property and owner-occupied real estate loans.

Construction / Completion Risk

Construction/completion risk applies to all types of real estate construction and development loans, regardless of the purpose or product type.

Risk areas include:

- <u>Built According to Plans and Specifications</u>
- <u>Built within Local Codes and Ordinances</u>
- <u>Built on Time</u>
- <u>Built within Budget</u>
- <u>Qualifies for Clear Title — construction liens</u>
- <u>Casualty, Fire, Death</u>

Construction Management

Construction management entails establishing a high level of expertise on a number of fronts, including managing relationships with municipalities, contractors, subcontractors, utility providers, architects, engineers, and other parties who must be held accountable for an on-time and within-budget performance.

When engaging in construction financing, you as lender also must have or be able to access high level professional expertise. You need expert knowledge of construction and construction finance to ensure thorough diligence and adequate **<u>contingency reserves</u>**. This is particularly true where incomplete permitting, land work, renovation, or innovation are involved.

The risk inherent in real estate construction lending cannot be over-emphasized.

Client Selection - Homebuilders

Preferred characteristics include:

Demonstrated experience with the product type, price point, and the markets where the product is located, with a strong preference for experience preceding the Great Financial Crisis.

Financial capacity to not only support ongoing operations, but to also withstand unfavorable market conditions, as the industry is cyclical and seasonal.

Operational capacity for their planned level of activity, to include sufficient management and succession depth.

Balanced inventory levels, at the subdivision, Builder and market level, which typically equates to a 6 - 8 month supply of homes (months' sales), and an 18 - 24 month supply of lots.

Information Needed - Homebuilders

Historic financials for Borrower and Guarantors, and Borrower projections

Detail on commitments with other lenders, to include key terms and covenants

Inventory report detailing all houses, lots and land (including inventory held in outside entities), their location, unit age, unit status (presold / spec / under construction), projected sales price, loan commitment and outstanding balance.

Detailed Business Plan, or information supporting: 1) Builder’s target product types, price points and markets, 2) Equity sources, 3) Lot sources (external or internal) and funding source, and 4) Organizational chart and succession plan.

Third party market data detailing local home and lot inventory levels, and activity levels at the Builder’s price points (Zonda, broker feedback, etc.).

Types of Homebuilder Lines of Credit

Advised Guidance Lines, also known as a Secured Credit Limit, include a separate Note for each home or lot.

Master Note facilities include one note, and separate unit level tracking. Advances are based on availability at the unit level, and are funded <u>after</u> construction costs and progress are reviewed and verified by the Bank via inspection.

Borrowing Base Facilities are a type of Master Note, with advances based on cumulative availability at the note level, and funded <u>before</u> sample inspections of construction progress are completed. A Borrowing Base is reserved for larger clients with strong underwriting metrics and reporting.

Line structures may also include limits on product types and subdivisions, which are intended to avoid excessive risk concentrations.

Line Structuring – Leverage and Liquidity

Leverage and Liquidity are key considerations in structuring and underwriting.

Leverage reflects the level of equity retained in a Builder’s assets, and Liquidity reflects the Builder’s ability to access that equity. Most Lenders have a strong preference for Builders who retain a meaningful portion of their earnings, and maintain a meaningful level of Liquidity, as they serve as cushions against the effects of cyclicality and seasonality. Lenders are typically willing to extend less restrictive structures as Builder Leverage and Liquidity positions improve.

Builder Liquidity is commonly reflected in their Working Capital position. Why look at working capital, and not cash? Most Builders prefer to pay down their Lines, and as such they retain liquidity via Line availability. That being the case, Working Capital frequently provides the most accurate representation of a Builder’s effective liquidity.

Line Structuring – Common Parameters

Structure	Maximum Global Leverage	Minimum Global Working Capital
Secured Credit Limit	4x D/TNW	10%-20%
Borrowing Base	2.5x D/TNW; 4x FD/EBITDA	20%-30%
Unsecured	1.0x D/TNW; 2x FD/EBITDA	30%-40%

As noted in the prior slide, and as illustrated above, most Lenders are willing to extend less restrictive structures to Builders as their Leverage and Working Capital positions improve. Please note that these ratios are global vs Line-specific, as most Builders secure funding via multiple bi-lateral credit facilities.

Unsecured lines are extended to national or super-regional Builders who possess qualities similar to comparable C&I clients that qualify for unsecured financing.

Line Structuring – Additional Considerations

Sample Covenants and Controls:

- Speculative and lot commitments may not exceed 65% of the Line
- Specs will be limited to 20 units and lots will be limited to 4 units
- 1 spec at a time in XX S/D
- Lots will be advanced at 75% of cost / 65% LTV
- Specs advanced at the lesser of 75% LTV, contracts at 80% LTV, or 100% LTC
- Annual financial statements and tax returns and quarterly sales/inventory reports on Builder/Developer, and annual PFS and tax returns on Guarantors
- A&D – minimum release fee, GC bonding, plan & specs review, final site plan approval, development permits, and evidence of all required approvals for the # lots, lot purchase contract

Underwriting – Balance Sheet

Essential Categories and Questions

These are the major asset and liability categories that are important for a Lender to review.

Assets	Liabilities
Cash	
Trade Receivables	Trade Payables
Land held for development	Land carry loans
Land under development	Development loans
Construction in process	Construction loans
Finished inventory	
	Other debt
	Net worth

Underwriting – Balance Sheet

- *Compare each asset line with its corresponding liability.* Determine whether properties are using cash or generating cash. The goal is to determine unencumbered cash. Mentally reduce all assets to cash.

- *Examine receivables.* How collectible are the receivables?

- *Look at land held for development and compare it with the amount of land carry loans.* Excessive carrying costs on land held for development can dramatically impair profitability, and excessive loans can drive up leverage.

- *Ask for detail about all land held for development, land under development, construction in process, and finished inventory.* Look for properties that never (or very slowly) move from one category to the next. Is there troubled project "buried" among one or more successful projects?

Underwriting – Balance Sheet

• *Examine finished inventory.* Stale inventory (completed homes not sold within six months) means excessive carrying costs.

• *Investigate partnership interests.* Is the borrower a general or limited partner? What future obligations does the Borrower have to invest in the partnership(s)? What is the basis of value?

• *Perform a debt analysis*. For each loan, is the borrower in compliance with the credit agreement? Do they have additional exposure beyond the amount of the debt? For example, via cross-collateral, default, or cross-default clauses?

• *Identify contingent liabilities.* Any there outstanding guaranties, letters of credit, or surety bonds? Are there any pending legal actions? Are all tax obligations current? While seldom shown on a financial statement, these are material to your analysis.

Underwriting – Income Statement

Limitations of Trend Analysis

The financial analysis of a residential developer differs from that of a manufacturer or service company. The traditional analyses of sales or revenue trends do not necessarily help predict future financial results because the developer's revenue from sales of finished homes, as well as excess land and lots, fluctuates from year to year depending on the local market and other external forces.

As you review the developer's historical sales and revenue trends, keep in mind your historical local market conditions. Remember that unlike a manufacturer or a wholesaler, a home developer cannot make fine-tuning adjustments to inventory levels during times of slow sales. Similarly, with the possible exception of executive compensation, there is not much opportunity to reduce recurring expenses with existing product if markets change.

Underwriting – Income Statement

Gross Profit Margin

You can measure the level of profit a developer consistently generates on the sale of completed homes. By measuring the gross margin, you can see if, from year to year, the developer knows how to make a profit at the unit level.

Gross margin is determined by deducting those items normally included by a bank in cost of sales from gross, selling price. Lenders should consider the following five items, although individual banks may use different items.

1. Closing costs.
2. Construction interest.
3. Land.
4. Direct labor
5. Direct Material

Underwriting – Income Statement

Gross Profit Margin (continued)

Sales commissions are not generally included in cost of sales. However, local single family home developers are sometimes inconsistent from year to year as to which costs are recorded in which income statement account. Lenders should develop a system to compare the income statements of one developer from year to year and to compare these statements with statements from other developers.

A healthy gross margin that is consistent from year to year is a strong indicator of a well-managed developer. A gross margin that is historically weak or inconsistent suggests the developer may not understand his or her market (and thus may not price adequately), or development costs, or both.

Underwriting – Income Statement

Nonoperating Revenues

Revenues can be generated through areas other than the sale of finished lots or production housing inventory. Asset sales such as excess land and lots to other builders also can generate revenue. Such sales should be isolated into separate nonrecurring or extraordinary revenue categories.

Variable Operating Expenses

With the possible exception of executive compensation, there is not much opportunity to reduce recurring expenses if market conditions change. Keep in mind that executive compensation oftentimes provides the cash flow needed to meet Borrower tax or off-balance sheet obligations, such as Land loans.

Evolving Market Conditions

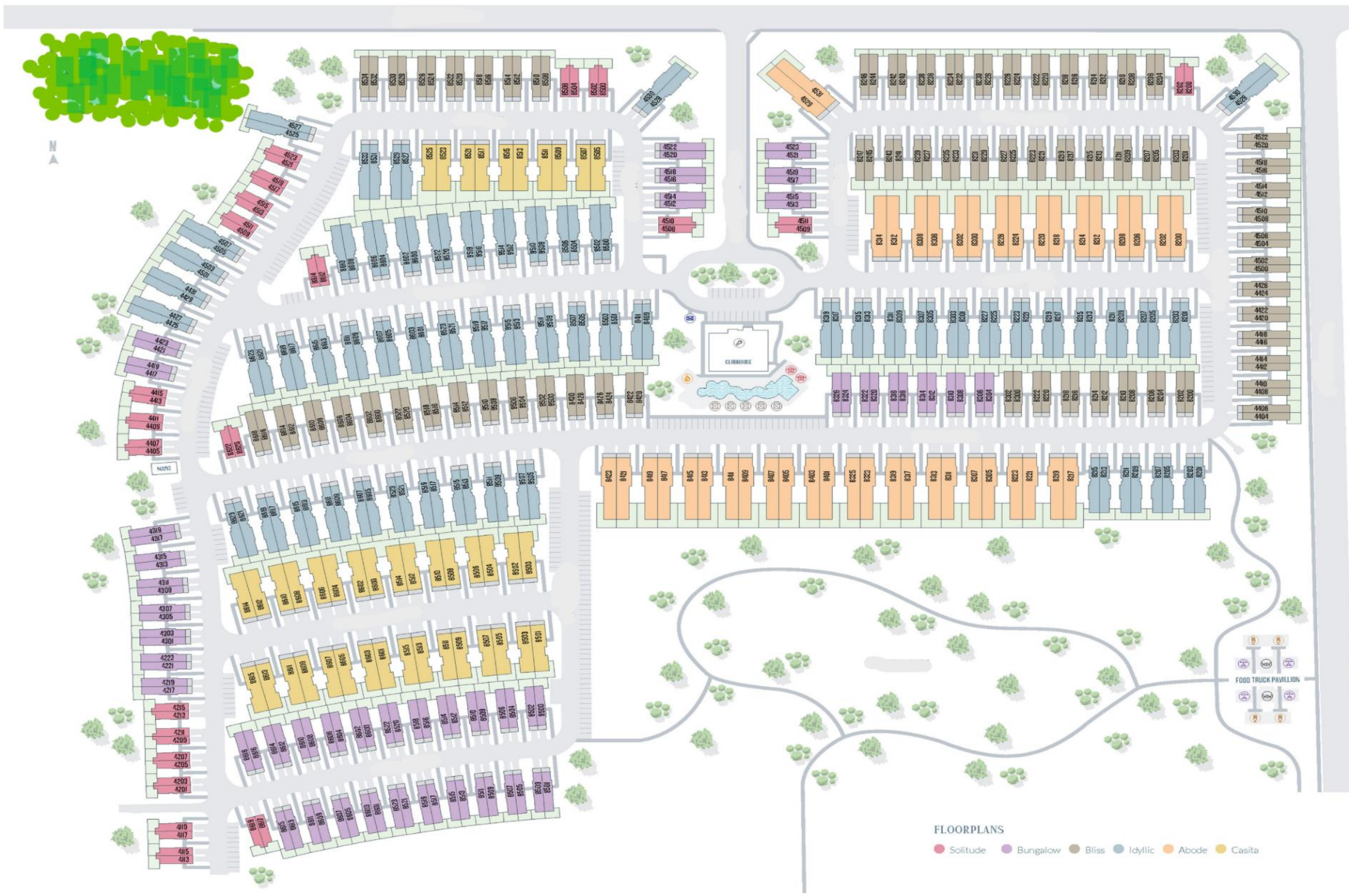
These are unusual times! Exercise caution when you see or hear:

- Builder is unable to provide interim reporting, projections, or trailing contract sales or cancellation detail upon request
- Significant reduction in contract activity – <u>the</u> leading indicator of closings
- New spec or lot takedown requests when effective inventory is elevated
- Projections that deviate materially from peer expectations, or appear unsupportable based on trailing Borrower activity
- Limited liquidity or immediate available loan finding
- Stable or increasing overhead when contracts are declining
- Material Builder A/R or A/P – suggests a shift to BFR, possibly GC activity
- Concentration of or reliance on BFR or investors
- Change in management, business strategy (BFR) or product mix (luxury exurb)

Build For Rent – Key Considerations

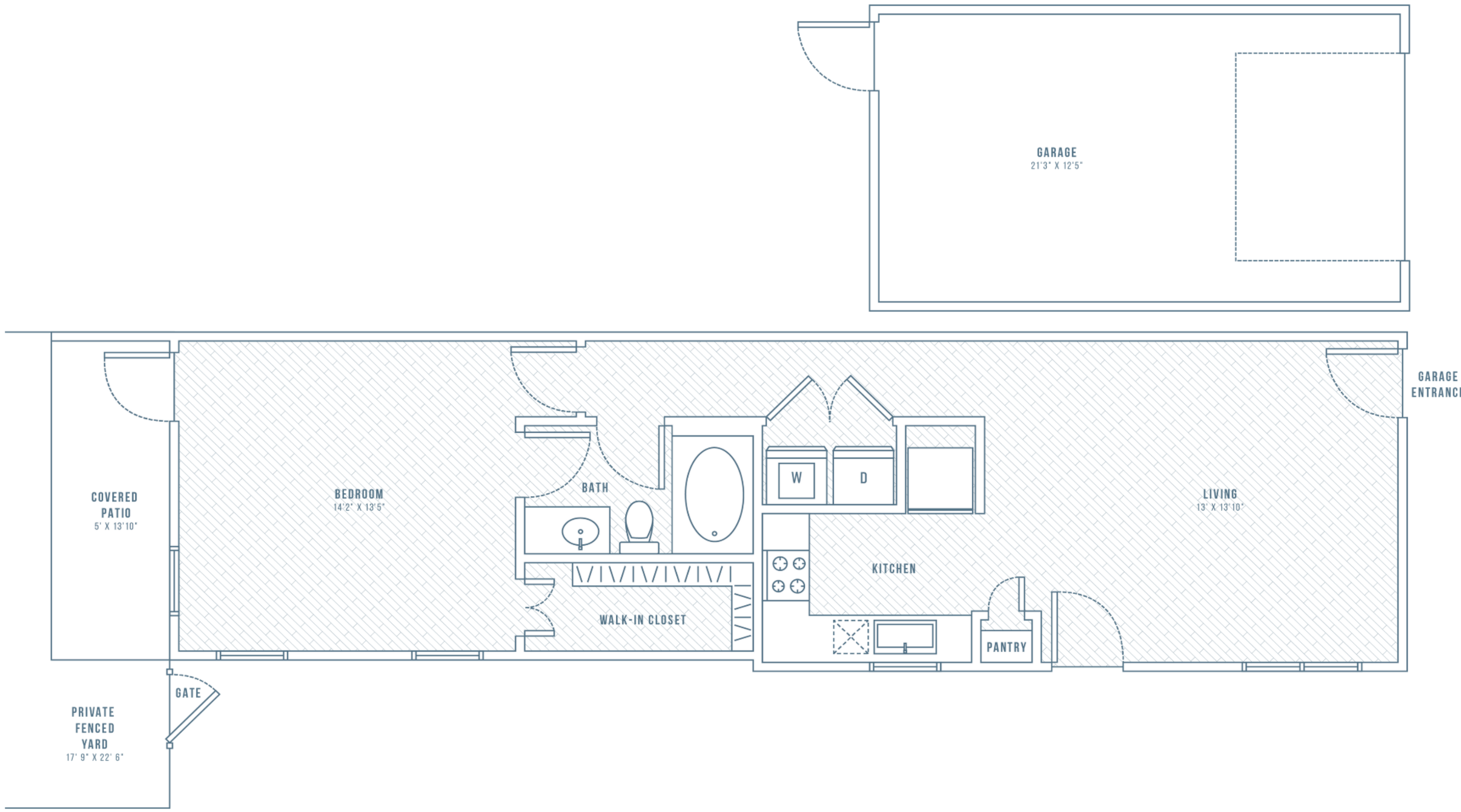
- Rapid expansion in this sector offers opportunities for BTS Builders
- Units are frequently standardized, offering economies of scale in construction
- BFR projects are commonly owned in a SPE, on Land zoned Mulitfamily
- Units are typically the property of the developer, with the Builder acting as GC
- Unit designs lend themselves to rental vs for sale marketability
- Builders acting as GCs are changing their own business model
- Builders acting as GC will face unique working capital and other issues
- Reversion to BTS requires remobilization, with potential cash flow issues

Build For Rent – NextGen Site Plan



Build For Rent – NextGen Unit Design

Build For Rent – NextGen Floorplan



Lending to Single Family Residential Lot Developers

Client Selection – Acquisition & Lot Development

Similar to Builders, preferred characteristics include:

Demonstrated experience with the product type, price point, and the market where the product is located, with a strong preference for experience preceding the Great Financial Crisis.

Financial capacity to support ongoing operations and unfavorable market conditions, and operational capacity for their planned level of activity, to include sufficient management and succession depth.

Most Lenders prefer to provide single family lot acquisition and development financing to existing Builder clients who are developing lots for their own use. Selected Lenders will provide lot development financing to dedicated merchant Developers, subject to a presale contract with one or more reputable Builders. Land loans should be reserved for clients with exceptional financial strength.

Information Needed – Merchant Developer

Presale contract, preferably with a national or regional Builder with demonstrated financial capacity covering all lots to be developed, to include a meaningful non-refundable Builder deposit.

Borrower and Guarantor financials, with a detailed schedule of all current Developer projects, including partially owned projects and commitments with other lenders, to include key terms, covenants and status.

Detailed project Budget supporting the sufficiency of the requested Loan to finance the entire development, with the lot development proforma. Exercise extreme caution when considering a revolving lot development facility.

Third party market data detailing local home and lot inventory levels, and activity levels at the builder’s price points.

Underwriting Considerations – Lot Development

Keep the following in mind:

Lot prices should be in line with final home prices, and typically no more than 1/4 - 1/3 of the final home price.

The construction budget should be based on contracts and include a reasonable contingency line item.

All zoning, entitlements and easements should be secured before Bank funding. Loan term generally should not exceed 36 months, and should include curtailments to ensure Bank repayment is aligned with the presale contract and appraisal proforma.

Appraisal and market data must support the lot sales prices, final home prices and the proforma take down schedule as shown in the contract.

Appendix A

Single Family Condominium Lending

Key considerations:

- Sponsor should possess relevant experience with the product type and provide strong financial support to mitigate construction and market risk.
- Product needs to fit the market from a price, square foot and amenity perspective.
- Presale contracts should include meaningful deposits and should be limited to individual buyers who intend to occupy the unit.
- Each state has unique requirements around the use of buyer deposits in project funding.
- Appraisal and market data must support the unit prices and the sellout schedule per the Borrower Proforma.
- Most Lenders require a minimum of 50% presales, with a minimum payout ratio of 80%, to demonstrate market acceptance.

Appendix B

Construction Management

Single Unit Construction Loan Inspection Worksheet

ITEMS COMPLETED	%	1ST	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
Clear Lot- Rough Grade	2	X									
Footings	2	X									
FND- Floor Frame/Slab	6	X									
OS Studs, Plates	3	X									
IS Stud, Ceiling Joist	4										
Wall sheathing	1	X									
Roof Framing & Sheathing - Felt	5										
Rough-in-Plumbing	4										
Rough-in-Wiring	3										
Rough-in Heat	4										
OS WND & Door Frames	4										
Permanent Roof	2										
Siding/Veneer	8										
EXT Trim	4										
Dry/Plast - Finish	6										
Bath - Tile	4										
Furnace	3										
Septic Tank - Sewer - Water	2										
IS Trim - Panel- WD Floor	5										
IS Doors	2										
Cabinets	3										
Hardware	2										
Interior Paint	2										
Plumbing Fixtures	4										
Wiring Complete- Fixtures	2										
Floor Covering - Carpet	4										
Finish Grade-Grass-Landscape	1										
Date Inspected		7-Aug									
TOTAL	100%	14%	0%	0%	0%	0%	0%	0%	0%	0%	0%

Appendix C

Construction Management

Sample Lot Development

Project Budget

Project:	Route 50 Acres
Location:	US Route 50 @ State Route 100
Land	$975,000
Engineering/Financing	$200,000
Streets w/curb, gutter sidewalks	$590,000
Storm Sewer	$206,000
Storm Water BMP	$ 25,000
Gravity Sewer Lines	$121,000
Sewer Force Main	$26,000
Pump Station	$275,000
Boring under Rt. 100 (HRSD)	$15,000
Water Main	$147,500
Fire Hydrants	$18,000
Street Lights	$15,000
Lot Stake Out	$39,400
Interest	(Funded by sponsor)
TOTAL COST	$2,671,400