HOMEBUILDERS

OVERVIEW

The business of home building typically consists of purchasing and developing land or lots and constructing and selling residential developments and land or lots. The neighborhood development process generally consists of three phases: land acquisition, land development and home construction and sale. Generally, this involves acquiring land that is properly zoned and is either ready for development or, to some degree, already developed. A homebuilder usually owns a substantial amount of developed and undeveloped land primarily to support its homebuilding activities, but it could also sell land or lots to other homebuilders and homebuilders. The homebuilder may also enter into joint ventures with other builders and homebuilders for land acquisition, development and other activities. The growth strategy of the majority of homebuilders usually focuses on organic growth opportunities through land acquisition and development in existing local markets.

The residential homebuilding industry is sensitive to changes in regional and national economic conditions such as job growth, housing demand, housing supply, availability of financing for homebuyers, interest rates and consumer confidence. Demand for housing is fueled by consumer confidence, affordability of homes, stability of home prices and the ability of homebuyers to sell their existing homes. The withdrawal of speculative buyers from the market also impacts demand. Adverse changes in any of the primary demand drivers on a national level, or in the markets where the ratee operates, are likely to have negative implications on its business, revenues or earnings including decreased value for the land, housing inventory and housing work-in-progress it owns. The homebuilding industry is highly competitive and fragmented. Competition in the industry has historically occurred at a local level.

The key areas that ECRL covers in assigning a rating to a homebuilder are:

- Business Risk Analysis
- Financial Risk Analysis
- Management and Other Qualitative Factors
- Issue Structure and Terms

BUSINESS RISK ANALYSIS
Industry Outlook

The home building business entails significant risks including:

- Market cyclicality;
- Exposure to fluctuations in the market value of undeveloped land, development sites and housing inventories arising from changing economic and market conditions. Land valuation adjustments or impairments and pre-acquisition costs write-offs could adversely affect the ratee's operating earnings and operating margin;
- Cancellations of sales contracts in backlog by customers who are unable to obtain mortgage financing or fail to complete the purchase for other reasons.
- Exposure to the adverse effects of increases in interest rates on housing demand;

- Inability to pass on unanticipated increases in construction costs to customers who have already entered into sales contracts that fix the price of the home at the time the contract is signed;
- Shortages of building materials and skilled labor which could result in construction delays;
- Potential changes in regulatory requirements which could increase costs and cause delays in land development and homebuilding activity;
- Decrease in the supply of suitable land at reasonable prices which could limit the homebuilder's ability to develop new neighborhoods or result in increased land acquisition costs; and
- The occurrence of natural disasters or adverse weather conditions that could delay completion of new homes and negatively impact the demand for new homes in the affected areas.

In light of the above industry characteristics, ECRL's rating approach will favor ratees with more seasoned management teams and track records of operating successfully through business cycles.

Competitive Position
ECRL considers the following to be important drivers of a property homebuilder's market position and competitiveness: location/market, sales price, construction costs, design and quality of homes, customer service, marketing expertise, availability of land, price of land and reputation. ECRL views the ability to acquire land in desirable locations and on favorable terms, to plan neighborhoods according to local demand, to anticipate consumer preferences in specific markets and respond to changing preferences of its target market as competitive strengths. ECRL examines the ratee's project quality record in respect of its past projects and on-going projects and its overall reputation as a homebuilder.

The homebuilding industry is highly competitive. Increasing levels of competition from other homebuilders in the local markets in which the ratee operates could reduce its sales volume or cause it to accept reduced margins in order to maintain sales volume. Homebuilders also compete with secondary market sales or resales of existing or foreclosed homes, homes offered by investors and housing speculators and available rental housing. Increased competitive conditions in the residential resale or rental market in the local markets where the ratee operates could decrease demand for new homes, pressure it to increase its sales incentives or price discounts in order to maintain sales volumes, increase the volatility of the market for new homes or lead to cancellations of sales contracts in backlog, any of which could have an effect on its operating results.

Operational Analysis

Construction costs are influenced by various factors, namely:

The amount of earthworks required Buildings constructed on land with a high gradient or housing projects constructed on land with undulating gradient would necessitate a higher expenditure for earthworks, foundation.

- The type of soil: This would influence the construction cost for the foundation of the building. For large projects especially if they involve high rise buildings, it is advisable to conduct a soil test especially if the soil consists of limestone or reclaim land or is a former mining land. If the area is rocky, the costs of earthworks and foundation would be higher.

- The design: For aesthetic reasons, some buildings are designed with unique features. This can result in higher construction cost but buildings which are considered aesthetically pleasing can command a premium.
- The height of the building; this would have a direct impact on the cost of the foundation required and the construction of the additional floors would require additional building materials.
- Finishing: The finishing used would influence the cost of construction. The use of more expensive materials such as marble slab instead of concrete titles would increase the cost of the building. The cost of the finishing for a building can range from around 10% (basic) to 20% (extensive) of the total cost. Other than the above factors, a change in Government policy can indirectly influence the cost of construction. The price of certain essential building materials such as steel and cement are heavily influenced by the Government. Therefore, any changes in Government policy in this area would influence the cost of construction and quality of entities (subcontractors, etc) deployed in execution.

While the homes are being constructed, the main risks are to complete the project on time, within the projected construction cost and acceptable workmanship quality. ECRL also assesses the homebuilder's project execution resources and capabilities, as reflected in its track record with respect to past projects, adherence to time schedules on ongoing projects, as well as its dependence on contractors and the ability to manage its contractors. ECRL reviews the track record of the main contractor to determine its ability to complete the project on time and its reputation for workmanship.

Given that raw material prices may fluctuate due to various factors, including demand or supply shortages, ECRL looks at mitigating measures adopted by the ratee to help limit the effect of commodity price increases on its operating results which could include: fixed-price contracts with contractors and material suppliers; utilizing standardized materials available from a variety of sources; leveraging its volume through quantity purchase discounts when purchasing building materials.

FINANCIAL RISK

Evaluating the Financial Risk of the Issuer is an important component of a rating exercise. An evaluation of the Financial Risk would entail an analysis of the following factors:

Profitability

The sustainability of a company over the long term depends on its profitability. In analyzing the profitability of a company, it is important to analyze the earnings before interest, tax, depreciation and amortization. Of equal importance is to review the earnings growth trend and return on assets.

Cash Flow

While it is important to review the cash flow of an Issuer for any debt issue, the review of the cash flow for a project under development is essential whilst the project is in the construction stage. When reviewing the cash flow of an ongoing project, it should be noted that funds from any bridging loans are usually released against Architect's Certificate of Works Done. The main components of a cashflow are:

- The cash inflow which would depend on two main variables i.e. the take up rates of the properties and the construction schedule. Deciding on the potential take up rates and the timing of the launches are highly judgmental. If the analyst is unfamiliar with the market conditions in respect of the locality of the property under financing, it would be advisable to discuss with property valuers and real estate agents who are familiar with that particular market.
- Since the progress payments billings are based on the Architect's Certificate of Works Done, the pace of construction would determine the cash inflow. Normally, there would be a delay of a few months between the time the construction cost is incurred and the proceeds from the progress billings are received.
- Once the construction schedule has been determined by the homebuilder, the cash flow can be determined.
- After the cash inflow and outflow have been computed, the financing requirement will then be known. The Purchasers would often obtain Housing/Term Loans from financial institutions (the End-Financiers). The end financiers would release the redemption sum directly to the bridging financier. It should be noted that the first 10% (paid upon signing of the Sales & Purchase Agreement) usually is credited directly into the HAD account and would not be used to redeem the property purchased. It is only the subsequent progress payment proceeds that would be used to redeem the property. The standard Sales & Purchase Agreement sets out the percentage of the Sales & Purchase price that can be billed regardless of the actual construction cost. For example, if a house is constructed on a hilly terrain, the actual cost for the foundation could be more than 10% of the Sales & Purchase price, but under the standard Sales Purchase Agreement, the Homebuilder can only bill 10%. After the framework for the cashflow has been prepared, different scenarios such as changes in interest rate or take up rate or construction cost can be easily generated. The stress test could than be carried out and the viability of the project assessed.

Capital Structure/Financial Flexibility
This is the ability of a company to repay its debt especially under conditions of financial stress is correlated to its Capital Structure and Financial Flexibility. Key considerations for assessing the Capital Structure and Financial Flexibility of a company are as follows:

- Unencumbered Assets: The availability of unencumbered assets would allow the Homebuilder to raise additional funds (either by sale of the asset or as security for loans) in times of financial stress. The presence of unencumbered assets also enhances the recovery rate for the unsecured lenders in a liquidation scenario.
- Un-utilized credit lines: Ideally, this should be sufficient to cover one year's cash requirement.
- Short Term Debt Debts maturing in less than one year (or short term debt) should be less than 10% of the total debt. A concentration of short term debts can pose a risk to the company in times of financial stress as the possibility of lenders recalling the short term debts increases.
- Debt leverage The Homebuilder should have a low debt leverage ratio and a high Debt Service Coverage Ratio. Homebuilders that have a more stable income (e.g. from a stream of continuous housing projects or a significant recurring rental income stream) can support a higher level of debt leverage. Similarly, Homebuilders that can command a premium on their housing projects (i.e. enjoy a good market position) and have higher gross profit margins can support a higher debt burden. When measuring debt leverage, it would be good to adjust the carrying value of the

properties on the company's balance sheet to the current market value, where possible.

- Access to Capital Market Another important consideration is the ability of the company to raise additional funds from the capital market (for public listed companies). Important factors to consider are the Price/ Earnings Ratio and the Market Capitalization of the company.
- Dividend Payout The dividend payout ratio should be less than 50% of the profits to ensure that sufficient cash is retained in the company.

MANAGEMENT AND OTHER QUALITATIVE FACTORS

The track record of the Homebuilder in their past developments is also an important consideration. Since sales are often made before the completion of the property, purchasers would hesitate to buy properties from a Homebuilder who does not have a good market reputation unless the properties are sold at a significant discount to the market. Besides the management's track record, other factors to consider include:

- Corporate Structure: Having a major shareholder controlling the company can be a stabilizing factor and provide the management with the flexibility to focus on its long term plans. A level of integration (e.g. construction and manufacturing of building materials) would enable the company to enjoy economies of scale and enhance their profit margins.

- Management Depth: It is also important to assess the experience of the middle level management especially its operating and technical competencies. Another important consideration is how long the senior management has been operating as a team. Equally important is succession planning especially when senior management are near retirement age and have dominant roles within the company.

- Strategic Vision: The Management's strategic vision for the company and plans for its long term growth should also be considered. Does the company plan to grow organically or through acquisition? An aggressive acquisition strategy can stress the management team and the company may experience integration problems. When reviewing the company's plans for future growth, a comparison between projects in the pipeline and the company's resources needs to be undertaken to ensure that the company can complete the projects without straining its resources.

ISSUE STRUCTURE AND TERMS

The Issue Structure and Terms should be congruent with the business and financial profiles of the Issuer.

Factors to consider include:

- Tenure of the Bond
- Repayment schedule
- Ranking of the debt
- Coupon rate
- Designated Accounts
- Credit enhancements e.g. Bank Guarantee or Corporate Guarantee etc.

Debt issues for property development companies typically include Security and Support Arrangements. Examples of Security and Support Arrangements are:

- A lien over the property by depositing the document of title (a Memorandum of Deposit setting out the terms and conditions is usually executed). The holder (i.e. the Lender) of a lien would be able to sell the property pledged. However, before the property can be sold, judgment has to be obtained against the Borrower before the Lender can exercise its right of sale. This method of securing pledged property is seldom employed and when used it is most often for a short duration. To further enhance the security arrangement and to prevent fraudulent transfer or sale of the property, it might be necessary to lodge a Private Caveat over the pledged property.

- A Private Caveat by itself does not secure the pledged property since it does not entitle the Lender to sell the pledged property. As elaborated above, a Private Caveat is often employed in conjunction with a lien executed by way of a Memorandum of Deposit. A Private Caveat prevents any dealings in the property.
- Dealings include sale, transfer and lodgment of Legal Charge and Lien-holder's Caveat. A Private Caveat is valid for only six years.

- A Lien-holder's Caveat in contrast to a Private Caveat, entitles the holder to sell the pledged property in addition to preventing dealings in the property. However, to exercise the right of sale, the Lender would have to obtain judgment against the Borrower first. The lodgment of a Lien-holder's Caveat requires the physical possession of the title and the consent of the property owner.

- A Legal Charge over the property is the most secured form of security a Lender (Chargee) can take. As with a Lien-holder's caveat, a Legal Charge prevents any dealings in the charged property. However, unlike a Lien-holder's Caveat, the Chargee can foreclose on the charged property without having to obtain judgment against the Borrower first. Besides securing the pledged property under the provisions of the National Land
- Code, the Lender can also secure the pledged properties by way of a Debenture. Debentures are usually taken as additional security arrangement in addition to a Legal Charge or Lien-holder's Caveat. For specialized assets such as retail complexes and hotels, it would be advisable for the Lender to have a Debenture as part of the security arrangement. Specialized assets of such nature often take time to be realized and in the meantime the Lender might want to appoint a Receiver & Manager to safeguard the asset and prevent the owner from "stripping" the asset. The Bonds can also be secured indirectly by taking an assignment over the sales proceeds or rental proceeds. The assigned proceeds would than be used to service the interest and principal payments. Ideally, the assignor should have confirmed Sales & Purchase Agreements or Rental Agreements before the assignment. The assigned proceeds can be channeled into a designated account and the monies applied for approved expenses according to an agreed order of priority of payments. An example of priority of payments is as follows:

a. Payment of tax and other statutory payments.
b. Payments of fees and other expenses.
c. Payment into an Interest Service Reserve Account to service the interest payments for the Bonds.

d. Payment into a Reserve Account up to an agreed amount to fund any payment requirements under the Debt issue in the event there are insufficient funds in other designated accounts to make the required scheduled payments.
e. Payment into a Redemption Account to fund the redemption of the Bond. The assignment of sales proceeds and rental proceeds can be taken as additional security arrangement in addition to other security arrangement such as Legal Charge and Lien-holder's Caveat. The security arrangement can be further enhanced by the addition of covenants (restrictive and positive) as part of the Loan/ Facility Agreement. The uses of negative covenants that cap the debt leverage ratio are often used to mitigate the risk to lenders.

While covenants offer additional protection for the debt holders, they seldom protect bondholders against all risks. However it does indicate to the company's management the amount of risk the debt holders are willing to bear.

MONITORING
After the issuance of the Bonds, the Issuer requires close monitoring and reporting for any changes to the sales of the underlying properties, to the construction schedule of the development and any changes to the development plan. For completed and operating properties (such as retail complexes and offices) monitoring must also be done on a regular basis to check on competitors in the surrounding area and the management of the properties.