

Dealing with the Economic Environment

2004 International Builders Show

Las Vegas, Nevada

January 19, 2004

3:30 p.m. – 5:00 p.m.

An Outline of a Talk Given by Charles C. Shinn, Jr., President
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I. THE WORLD SCENE

- **International Terrorism Threat**
 - **Al -Quaida**
 - **Osama bin Laden**
 - **Threat of Terrorism on U. S. Assets**
- **Afghanistan**
- **Iraqi War and Rebuilding**
 - **Cost of Rebuilding Iraq - \$87 Billion**
- **North Korea Nuclear Treat**
- **Middle East Unrest**
- **Global Economy Recovering**
 - **Stagnant Economy in Key U.S. Trading Partners**

II. THE UNITED STATE ECONOMY

A. GOOD

- **Out of the Recession**
 - **2003 was a Strong Year**
- **Interest Rates are at a Historic Lows**
- **No Inflation – CPI rise 1.8%**
- **Stock Market Showing a Strong Recovery**
- **Presidential Election**
- **Federal Reserve to Hold Rates Down**
- **GDP Growth to Average 4.5% - Strong**
- **Consumers Continue to Set Pace**
- **Business to Increase Spending**
- **Washington to Increase Spending**
- **Unemployment will Drop to 5.4%**
- **Deflationary Threat Receding**
- **Consumer Attitudes Improving**
- **Business Becoming Optimistic**
 - **Increased Spending on Capital Goods**
- **Nonresidential Business Sector Strengthening**
- **Exports Boosted by Weak Dollar**
- **Rapid Growth of Labor Productivity – Tech Payoff**

B. BAD

- **Federal Deficits Too High**
- **Souring Trade Deficits**
- **Dollar will Stay Soft**
- **Employment Sluggish**
- **High Consumer Debt Burden**
- **Federal and State Government Deficits**
- **Inflation Concerns**

III. THE HOME BUILDING INDUSTRY**A. GOOD**

- **Thirteen Years of Strong Housing Demand**
- **1.8 Million Housing Starts – Highest since 1986**
- **New Home Sales Hit A Record of Over One Million**
- **Has Violated ALL Historic Economy Patterns**
- **Home Ownership Rate at an ALL Time High**
- **Housing Has Become an Investment**
- **Housing Prices Continue to Rise at Health Pace**
- **Drop in Number of Mortgage Refinancing**
- **Housing Start Up**
- **Housing Permits Up**
- **Price of Most Building Materials Relatively Stable**

B. BAD

- **Strong Escalating New Home Prices**
 - **New Home Affordability for Most Households**
 - **Growth Concentrated at the High End**
 - **Over \$300,000 risen from 14% to 23% Share in Two Years**
- **Skyrocketing Land Prices**
 - **Constraints on Supply of Land**
- **Homeowner Refinancing**
 - **Liquidation of Home Equity**
- **House Mortgage Delinquencies at a 30 Year High**
- **Sales Pace of New Homes has Eased**
- **Home Price Gains Moderating – 5.6% Slowest in Four Years**
- **Multifamily Vacancies High**
- **Housing Starts to Decline to 1.72 million**
- **Relationship with Jobs and Housing is Out of Whack**
- **Several Markets have already Softened**
 - **Almost a Third of Metro Areas Activity is Down**
 - **Denver**
 - **2003 Down 18% from 2002**
 - **2002 Down 20% from 2001**
 - **Other Markets appear to be on Borrowed Time**
- **Mortgage Interest Rates Inching Up to 7.0%**

- **Talk of a Housing Bubble**
- **Have we been Borrowing Sales for the Future?**

IV. THE HOME BUILDERS

A. GOOD

- **Enthusiastic – Confidence Still High**
- **Substantial and Rapid Growth**
- **Diversifying**
 - **Product**
 - **Geographically**
- **Survey Results on Planned Growth**
 - **68% Plan to Grow 10% or more**
 - **42% Plan to Grow 30% or more**
 - **21% Plan to Grow 50% or more**

B. BAD

- **Many Builders have NEVER experienced a Downturn**
- **Seasoned Builder seem to have Forgotten**
- **The “Midas Touch” Syndrome**
- **Rose Colored Glasses**
- **High Speed Wobbles**
- **Accumulated a lot of Fat and Inefficiencies:**
 - **Systems**
 - **Direct Construction Costs**
 - **Schedules**
 - **Staffing**
 - **Operating Expenses**
- **Profits are still Low**
- **Growth through Debt**
 - **Very Little Working Capital**
- **Not prepared for a Slowdown:**
 - **High Land Inventories**
 - **Bloated Operating Costs**
 - **Little Cash Reserves**
 - **High Leverage**
 - **Inefficient Construction**
 - **Extended Schedules**
- **Mentally NOT ready**
 - **Won’t make the necessary decisions early enough**
 - **Denial = Catastrophe**

V. THE RISK***UNCERTAINTY***

- Economic Conditions can change Extremely Rapidly
- For every Action there is a Reaction
- If you have a Downturn will it be Steep or Shallow, and Long or Short
- How much time do I have left?
- Where is my Growth Coming From
 - Natural Growth
 - Take from Competition
- Foreclosures
- Bankruptcies
- Don't Gamble Everything on a New Land Deal
- Time to get your Act Together

"I've been at the crap table for 12 years and let my winning ride. It's now time to take some of my money off the table. I'm still in the game but not letting ALL my money stay at risk."

VI. WHAT SHOULD I DO?

Get your House in Order!

Don't Wait Too Long!

A. Develop a Survival Strategy Now

What do I have to do Today to be ready for an Uncertain Tomorrow?

- Don't Wait until it's TOO Late
 - Proactive NOT Reactive
- B. Establish Three Pre-Planned Scenarios and Budgets**
- Based on Three Sets of Economic Assumptions
 - Project out for a Rolling Four Quarters
 - Establish Criteria for Implementation of each Plan

- C. What is your Survival Power (holding power)**
- Length of time you can hold out under worst conditions
 - Assumes no further Contracts or Sales
 - Only Income from Closing of Present Sales on Books
 - Should be at least 2 ½ to 3 months of Operation
- D. Build a Rainy Day Fund**
- Keep it Liquid
 - Don't invest in Construction Loans, or Real Estate
- E. Manage Your Risk**
- Don't bet the Farm
 - Keep Flexible
 - Don't Grow Too Fast
 - Geographical Diversification is VERY Risky
 - Improve Cash Flow Projections
 - Maintain a Minimum Level of Liquidity
 - Reduce Leverage
 - Close Unprofitable Operations
 - Get Rid of Low Gross Profit Product
 - Watch your Speculative Inventory
 - Don't become a Land Hog
 - Improve your Gross Profits
 - Get Rid of Bad Deals
 - Watch your Bottom Line
 - Don't be Volume Greedy
 - Keep your Breakeven Point Low
- F. Maintain Sales Velocity**
- Set Prices to Market
 - Adjust Construction Costs to obtain Target Gross Margin
 - Costs DO NOT create Value
 - Target Market
 - Develop a Realtor Program
- G. Reduce Construction Costs**
- Maintain Construction Costs at 50% or less of Sales Price
 - Analyze and Reduce Standard Specifications
 - Understand Customer Perceived Value
 - Conduct Customer Research
 - Don't Over do a Standard Feature
 - Put your Money In High Perceived Value Items
 - Eliminate Waste and Excess Material Usage
 - Police your Trash Piles
 - Eliminate Excess Material Usage

- Watch Diverted Materials
 - Monitor and Eradicate Variances
 - Develop Scopes of Work for Trades
 - Conduct “as-built” Audits
 - Value Engineer Plans
 - Improve Estimating and Purchasing
 - Implement a True Purchase Order System
- H. Reduce Cycle Times and Improve Inventory Turn
- Improve Construction Schedules
 - Master Construction Schedules
 - Schedule Pre-construction Activities
- I. Improve Efficiency
- Improve Processes
 - Improve Systems
 - Standardize Procedures
 - Reliable and Consistent
 - Efficient and Effective
 - Get Rid of Non-Valued Added Activities
- J. Develop Good Control and Management Reports
- Design from Bottom Up and Top Down
 - Two Minute Management Reports
 - Variance Reports
 - Not Data Dumps
 - Have to have a Purpose
- K. Balance Operating Expenses with Sales Volume
- Watch Staffing Levels
 - Invest in Systems instead of People
 - Analyze Processes for Efficiency

VII. SUMMARY

- A. Dynamics of Sales Price Changes
- Increase or Decrease in Sales Price changes the Marginal Rate of Profitability
 - *Sales Price increase of \$1,000 for a 100 unit builder increases profits by \$100,000*
 - *Sales Price reduction of \$1,000 for a 100 unit builder decreases profits by \$100,000*

- **Increase in Sales Price risks Sales Velocity**
 - **Discounting Sales Price might Increase Sales Velocity**
- B. Dynamics of Construction Cost Changes**
- **Decrease or increase in Construction Cost changes the Marginal Rate of Profitability**
 - *Reduction of Construction Costs of \$1,000 for a 100 unit builder increases profits by \$100,000.*
 - *Increases of Construction Costs of \$1,000 for a 100 unit builder will reduce profits by \$100,000*
 - **Reduction or Increase in Construction Costs Typically DO NOT impact Sales Velocity.**
 - **By reducing Sales Price dollar for dollar for construction cost reduction can increase the Profitability Rate and Sales Velocity**
- C. Dynamics of Operating Expense Changes**
- **Changing Operating Expenses DOES NOT change the Marginal Rate of Profitability**
 - *Changing Operating Expenses by \$1,000 will only change the profits by \$1,000.*
 - *There is NO Multiplier*
 - **Many builders will Increase Operating Expenses to Reduce Construction Costs because of the dramatic impact of reduced Construction Costs on Profits**

Now is the time to be proactive in developing a strategy for survival for a potential downturn. Maybe it won't come, but failure to plan could spell disaster. It is much better to be proactive than reactive. If you wait too long you will be in denial, delay critical decisions and risk the possibility of becoming another statistic in the annals of Homebuilder failures. Hopefully it is not too late.