THE PARLIMENT PAGES

JULY, 2013

THE FEDERAL RESERVE, THE STOCK MARKET, THE ECONOMY AND HOUSING –

Addressing the four of these in the same paragraph is virtually impossible. Not because they are such big subjects by themselves but rather because they are sending contradictory signals. First, let's look at the Federal Reserve Bank. They have stated that they will continue to support the economy through their bond purchase program (more about that later) as long as the economy shows no signs of real improvement and unemployment stays above 6.5%. The conundrum that this creates is quite interesting. As was seen in the past couple of weeks, just the hint of the Federal Reserve backing off on their support sent the stock market into a downward spiral. It was only after they retracted their inflammatory statements that the market recovered.

So, here is their situation. Support the economy while it is bad or quit supporting it and watch it get worse. Without the Federal Reserve support, interest rates would skyrocket, the mortgage market would tank and the fragile housing recovery would totally collapse. The end result is that the Fed finds itself in a position to continue its present policy, accepting slow growth and supporting the improving growth in housing.

HOW INTEREST RATES ARE DETERMINED –

I know we have covered this subject in some previous newsletters but I think it is important to review this one more time since interest rates are one of the most critical components to the growth of our industry.

We all know that the mortgage industry has been in the middle of the lowest rates in decades. Most of you are also aware that there has been a little upward pressure over the past month or so and accordingly rates have marched up less than a point from their historic lows. Let's take a minute and understand what drives long-term rates. In the mortgage industry, the bond markets drive rates. The lending institution that closed the mortgage transaction very rarely holds mortgages. Generally, that institution will collect their fees, package a bunch of mortgages together and sell them as a collateralized security. In many instances, those collateralized securities are offered up by Fanny Mae, Freddie Mac or any number of different mortgage clearing houses.

Those clearing houses will take these packages of mortgages and will sell them to investors at a bond market auction. If there are a lot of buyers for those packages, the demand is great and the interest rate will be low. Investors are looking to park money and in the auction, the demand determines how low of an interest rate a buyer will accept to get their hands on such a package.

One of the tools that the Federal Reserve has used to prop up the housing industry has been to buy these packages. These purchases are amounting to almost $45 billion per month. This artificial demand by the Fed has forced market interest rates low. If the Fed were to withdraw this support, there would not be enough demand to buy these mortgage packages. Without demand, the packagers would have to raise rates high enough to attract buyers. As they raise their rates, the institutions marketing the mortgages also raise rates.

This cascading effect quickly, within a matter of hours, works it way down the chain and you, as a home buyer, are quoted a new rate. In summary, one of the best indicators of future mortgage rates will be to carefully watch the Federal Reserve actions.

INTEREST RATE PREDICTIONS –

As we previously mentioned, the Federal Reserve is caught between the proverbial rock and a hard place. If they withdraw their collateralized mortgage bond purchases, housing will most certainly decline. Last week the Fed tested the market with their comments and what they saw was not pretty. They may try again, but we think the results will be the same and the market will react very negatively. Therefore, despite some starts and stops, we think that, over time, the basic program of buying mortgage-backed securities will continue at the current elevated rate.

Rates may go up a little and then settle back down, but we do not see any drastic increase that will put stress on the housing recovery. That is a good thing for our industry.

CONSUMER SENTIMENT –

The monthly consumer sentiment survey is always interesting to watch. By and large it has remained fairly constant despite the good, the bad, and the ugly news that seems to come out of Washington. After all, unemployment is still high, job replacements are at inferior wages, there is virtually no wage growth, core inflation of food and energy continues to rise, and there is little growth in our economy. That must beg the question of how consumer sentiment can be in its relatively lofty state.

Researchers are beginning to find that the general population has become immune to bad news and is accepting what was previously thought of as bad, as not so bad now. It is all a case of relativity. Prior recoveries were always in the 5%-7% range, lasted 2 or 3 years and then settled back. Our country has seen growth in the 1% to 2% now for so many years that we have come to accept that as the new normal. If we see that as normal, then the fear that so gripped everyone a few years ago will disappear. As that fear disappears, confidence comes back up and we start spending on major purchases.

This is another sign that points to a continued recovery in housing.

HOUSING VALUES –

There have been numerous headlines about the increasing home valuations. Following the most basic economic law, most increases in home valuations would seem to come from increased demand from homebuyers. Unfortunately, this does not appear to be the case this time around. When you really dissect the buyers of today, you will find that almost 40% of all real estate transactions are investor driven. Major private equity groups are investing billions of dollars into residential real estate. One major firm announced the completion of the purchase of 40,000 homes in Florida alone. That is staggering. It also shows that these “smart” money guys believe the bottom in valuations are way behind us and that valuations will continue to rise.

The question becomes whether or not this money will raise values up to the point where the home owner can no longer afford to compete and will instead revert to apartment or multi-family living. Evidence is strongly supporting that right now as the construction of multi-family units continues to exceed all expectations. Also supporting this, home ownership recently fell another 1% bringing that percentage to the lowest level in recorded history. People are renting more and buying less.

While this investor demand phenomenon is good for construction and values in the short run, it certainly raises flags for down the road. The first flag is squeezing the prospective home owner/buyer out of the market. However, even more troubling is the memory that it was investor purchases that really created the last housing bubble that burst with such violence.

This could be very good for our industry in the short run but could possibly have negative consequences long-term.

HOUSING SHORTAGES –

Another contributing factor to the increase in valuations is the shortage of new home inventory. Builders have, understandably, been reluctant to build a lot of speculative homes. With this lack of inventory combined with the increased investor demand, prices are forced upward. Again, this is some of the same recipe that led to our most recent problems. As the builders catch up with speculative inventory, we may see some cooling of prices.

This could have some positive impact on our industry as demand may switch back to the homeowner instead of the investor speculator.

PRODUCT SHORTAGES –

In our last two issues we warned of some potential product shortages. As you may recall, we thought those shortages would come because of the lag time in building up production capacity to meet the expected market growth.

We were right on with that prediction and found several severe product shortages in the last couple of months. In particular, many of the steel mills were caught off guard and were unable to provide adequate inventory for their customers. We believe this situation will continue in certain spot areas for quite some time. Please check with your supplier on a regular basis to see if there are signs of upcoming shortages. If so, take the steps necessary to build your inventory. Also, pick a supplier that you think will have product when you need it.

SUCCESSION PLANNING – PART 2 –

In our last issue we touched on the subject of succession planning and agreed to address it in more detail in this issue. In April I mentioned that the average age of an entrepreneurial owner in this country is about 59 years old. In many cases these are people who either started their business or possibly inherited it from a previous generation. They have generally worked their entire lives within their industry. As is true with most entrepreneurs, they were the first in each morning and the last one out the door at night. Vacations were a dream that never seemed to happen. Their businesses had their ups and downs and over the years the owners were able to accumulate some net worth.

However, most of that net worth was tied up in the business. Real estate purchases, growth of inventories and escalating receivables consumed every bit of spare cash that could be accumulated. Even though the checkbook never seemed to have much money in it, the balance sheet showed a lot of net worth.

Thoughts of retirement slowly begin to creep into their thinking. They talk to other successfully retired business owners and think that is the life they want. They go back and forth for a few years and then one day decide they have had enough and it is time to sell the business. They may start talking with some business brokers, financial advisors, accountants and friends. During this process they become more and more confused about how to actually approach the disposition of their business.

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WHO TO SELL TO? –

The first question is often, "who would be a buyer." Buyers will typically fall into two categories. There are the experienced "strategic buyer" who knows the industry and sees acquisitions as a path to growth. Then there are the inexperienced buyers who are probably sick of the corporate life and are willing to put their life savings on the line to be their own boss. Each will bring its own set of difficulties to the table.

Most often you will find the experienced buyer is the one who can truly see your business for what it is worth. Unfortunately, many times that buyer is a present competitor and the first thing he will want to look at is your financial statements, customer lists, vendor records and all sorts of other confidential information. Do you really feel comfortable giving him all of that information? Of course he will agree to sign a non-disclosure and confidentiality agreement. Sure, what good is that once he has all of your information? You have just armed him with a wealth of competitive information that could easily come back to haunt you at a later date.

Then you sit down with the inexperienced buyer and find he doesn't have enough cash to really buy you out and instead wants you to finance a big portion of the future payment. Let's understand that for exactly what it is. He is asking you to pay yourself out with future earnings of your company. This person does not know the industry, probably doesn't know what it is like to be an entrepreneur and now you are supposed to trust his ability to pay you in the future.

Neither of these options look particularly good, but what else is there?

HOW MUCH IS YOUR COMPANY WORTH? –

Mergers and acquisitions run through stages of various manias. In 2007, businesses in our industry were selling for astronomical amounts. Today, that is not the case as buyers now see that the industry is still struggling and the outcome is still quite uncertain.

Most financial people will tell you that businesses in our industry will typically sell for a multiple of earnings (goodwill) plus some asset value. Ranges will probably be between 4 to 5 times the earnings. However, here is where many entrepreneurs slip up. Let's face it, most small business people will run expenses through their company that are personal in nature. They will adjust inventory levels to minimize tax liabilities. All of these will deflate earnings, but the entrepreneur is ok because it lowers his tax bill. Now when you realize that the goodwill in your business in a multiple of earnings, you quickly find that you have depressed the enterprise value in an effort to save taxes.

For those of you who have invested in producing real estate such as your locations, you will find that the real estate is only worth what the property will generate in rents. If the business on the real estate is not profitable, then the rent figure will be depressed which in turn reduces the property value.

WHAT TO DO? –

We have just touched on a couple of the many issues that owners face as they look towards their next chapter. In the next issue we will delve into a couple of additional areas. One, in particular, that we will explore is the transition of ownership to the next generation or to an existing second tier management group. For the first time in several years, banks are showing more interest in our industry. With banking support, these types of transactions may start to increase. Timing is everything and it typically will take between one and three years for a successful business transition. If you would like to confidentially discuss this further, please call either Chuck or Jim.

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