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U.S. construction industry is ready for a blowout

by Anthony K. Wikrent

U.S. home builders are screaming for relief from new savings and loan regulations that have dried up all credit for new home construction. Housing and Urban Development Secretary Jack Kemp has promised that the Bushmen will come up with some program to help, but under prevailing axioms of policy, the U.S. physical economy is now collapsing so rapidly that there is no way to prop up the housing market without triggering a hyperinflationary spiral. The problem is made even more dangerous by the impossibly high levels of debt being carried by some of the largest home-building and construction materials companies that have been involved in highly leveraged transactions (HLTs), known as leveraged buyouts.

The National Association of Home Builders held its annual convention in Atlanta in January, and "the most immediate thing on everybody's mind," according to NAHB Staff Vice President Jay Shackford, were the new "loans to one borrower" rules imposed on savings and loan associations. Under the new rules, imposed by the Comptroller of the Currency in August 1989, S&Ls are not allowed to loan more than 15% of their capital to any one borrower, as compared to 100% previously.

With the 15% limit, many home builders who had developed close working relationships with their local S&Ls over many years, or even decades, suddenly found themselves cut off from their traditional source of credit. Some builders were even compelled to abandon construction in the middle of a project.

The effects were not long in making themselves felt. Housing starts have fallen to their lowest level in seven years. From the January 1989 annualized peak of 1.678 million seasonally adjusted housing starts, construction of new homes slid 24.7% to 1.264 million starts in September, then bounced up in October before collapsing even further, to a seasonally adjusted rate of 1.235 million in December. That left housing starts for the year of 1989 at 1.37 million, the lowest since the 1.06 million of 1982.

The latest survey of its members by the National Electrical Contractors Association showed that "slow collections from customers" (such as home builders) had replaced a lack of skilled labor as the leading problem, mentioned by 35% of the 315 contractors that responded. The comment of a contractor in Colorado was revealing: "Banks and S&Ls don't or won't lend the funds to do the work." Twenty-one percent of the contractors reported that sales declined in 1989, compared to 13% in 1988.

Administration's policy inadequate

President Bush spoke at the NAHB Convention, but steered clear of the S&L issue. Instead, Bush stated that he was in favor of lowering interest rates, and ran through a series of statistics showing that the demand for housing rapidly increases as interest rates are lowered.

But the collapse of the bond markets on Jan. 23, and the need to keep interest rates ahead of the Germans and Japanese in order to continue attracting foreign money, makes it impossible for the Federal Reserve to lower rates, as Bush desires. (See *Banking*, page 10).

Jack Kemp told the NAHB Convention that he would urge the Federal Home Loan Mortgage Corp., the Federal National Mortgage Association, and the Federal Housing Administration to develop a "joint venture credit facility" to meet the home builders' demands for credits. But Kemp's proposal, while welcomed by the NAHB attendees, is far removed from draft form, let alone implementation. The home builders are demanding that the Comptroller of the Currency grant a two-year transition period, while the details of Kemp's plan are worked out. Shackford points out that projects now under construction had their financing arranged before the "loans to one borrower" rules took effect, but by spring, and certainly by summer, the real crunch will be felt, when projects that are trying to arrange financing now—and can't—are unable to begin. As the incoming NAHB chairman, Martin Perlman of Houston, warned the *Wall Street Journal*, "Thrift reform left a vacuum in the production side of our industry."

If the federal government does not arrange new home construction financing in time, a financial shock wave is guaranteed by the failure of highly indebted large construction materials and home constuction companies. These companies, such as MDC Holdings, Inc., General Homes Corp., and U.S. Home Corp. were loaded with debt when they were bought out in HLTs over the past few years. Debt expense often exceeds operating revenue. Hillsborough Holdings, the front set up by LBO outfit Kohlberg Kravis Roberts and Co. to buy out home builder Jim Walter Co., already filed for bankruptcy on Dec. 28, 1989.

U.S. Home had over $1 billion in sales in 1983 and 1984 from operations in 29 metropolitan areas in Arizona,

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California, Florida, Texas, and nine other states, making it one of the largest builders of single-family houses in the country. The company has lost money in three of the past seven years. Despite having sold off many of its operations to buy down debt (sales are now around $600 million a year), its junk bonds were forced to offer a yield as high as 26% last summer, and the company was issuing more stock in lieu of cash to pay its bondholders.

General Homes, with sales of about $300 million in Houston, Dallas, Phoenix, Atlanta, New Orleans, and many areas in Florida, has been in default on its debt obligations for over a year, after losing $30.0 million in 1987 and $124.7 million in 1988. It has been trying to reorganize its finances by persuading bondholders to exchange their junk bonds for preferred stock.

MDC Holdings has operations in Arizona, California, Colorado, and the Washington, D.C.-Baltimore area. With sales of over $700 million in 1987 and 1988, MDC is also one of the largest home builders in the U.S. Last year MDC sold its operations in Colorado in a complex transaction aimed at stopping the interest expense hemorrhage. MDC also tried to sell its operations in California last year, but without success. At the time, demand for land was so high, that purchases required cash up front—which MDC just did not have.

Other companies heavily involved in real estate are also likely to be hit hard by the collapse of home-building finance. Examples are Southmark Co., the real estate-based financial services company already in default on its debt payments, and Financial Trustco, which has about 15% of its revenues derived from real estate financing.

Suppliers also in trouble

Upstream from the home builders, USG Corp., the world's largest producer of gypsum and wood fiber hardboard products, and National Gypsum Co., about half the size of USG, are both struggling under huge debt loads, with their junk bonds forced to offer premiums of 20% or greater, according to a study done by Morgan Stanley in October. The third major U.S. producer of gypsum products is Celetex, a subsidiary of Hillsborough Holdings, now in bankruptcy.

No better example of the financial and economic insanity of the Anglo-American elites can be found than that of USG, founded in 1901 as the United States Gypsum Co. by the merger of 35 gypsum producers. Gypsum is a major component in wallboard, plaster, and portland cement. There is no practical substitute for its use in cement as a retarder. In 1905, Sewell L. Avery took charge of the company and built it into the largest processor of gypsum in the world, supplying a third of U.S. demand for gypsum products. Avery epitomized a true captain of industry: He deeply mistrusted the

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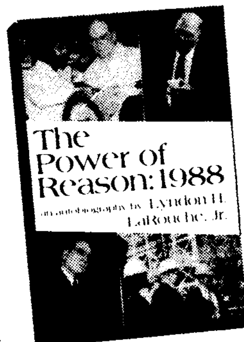

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pirates of finance, and during his 46 years in charge, United States Gypsum *never borrowed a cent.* Avery's aversion to debt helped his company weather the Great Depression rather well: It was one of the few companies that was able to continue paying a dividend to its shareholders.

In 1987, USG came under attack by Desert Partners, an unlisted Midland, Texas front for corporate raiders Brown and Wagner, who had worked with T. Boone Pickens. Despite huge paper losses, Brown and Wagner stepped up their acquisition of USG after the 1987 stock market collapse. In 1988, the management of USG decided to ward off Brown and Wagner's threat of a hostile takeover by assuming a staggering $3.1 billion in debt in July, blasting the net worth of USG from plus $609.8 million, to negative $1.471 *billion.*

"We decided that we were best equipped to run this business with that level of debt—certainly better equipped than Wagner and Brown," Matt Gonring, a spokesman for USG, explained. "Was it possible to avoid the debt? We looked, and it seemed there was no other way." As a result, USG's interest expense soared from $34.2 million in 1986 and $69.2 million in 1987, to $178.3 million in 1988 and $287 million in 1989. USG reported the first quarterly loss ever in its 88-year history in early 1989, but has since brought down its debt by selling off three divisions, including Masonite, which had sales of up to $500 million annually.

But, Avery's policy of ploughing a large part of the profits into new and more efficient capital equipment was abruptly abandoned. Capital spending was slashed, and 500 of USG's 15,000 employees were dismissed. "We were a company that used to keep our facilities up to date," Gonring stated, "always buying the latest, most efficient equipment. So, we were in a position where we could go a few years without reinvesting, and it wouldn't hurt us very much. But you can't do that forever."

Spending on research and development was also curtailed. "We shifted to projects that were focused on less capital requirements, and products that have a shorter lead time to the market," Gonring explained. "We can't afford to abandon R&D, like many other companies do after a recapitalization. In this business, R&D is the lifeblood of our future. Would we like more money for R&D? Yes! But, you have to restructure your operation as tightly as possible. We reduced the support staff, and tried to keep the Ph.D.'s."

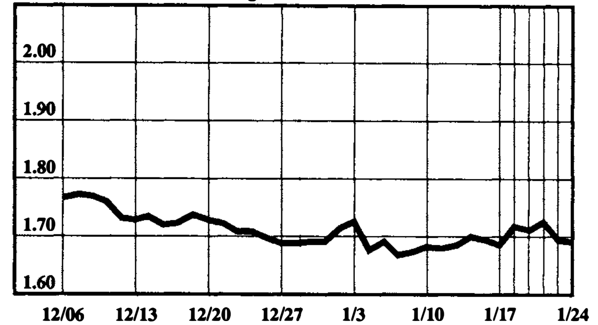
In October 1989, the company sold its 19-story Chicago headquarters building for desperately needed cash. USG signed a lease, and is now paying rent to remain in its former headquarters until 1992!

USG also brought a suit against Merrill Lynch, which had advised Brown and Wagner. Fourteen months earlier, USG had retained Merrill Lynch to advise it in its acquisition of Masonite Co. USG charged that Merrill Lynch improperly used inside information it had gained as USG's adviser, to help Brown and Wagner. Merrill Lynch chose to settle out of court rather than go to trial.

Currency Rates

The dollar in deutschemarks

New York late afternoon fixing



The dollar in yen

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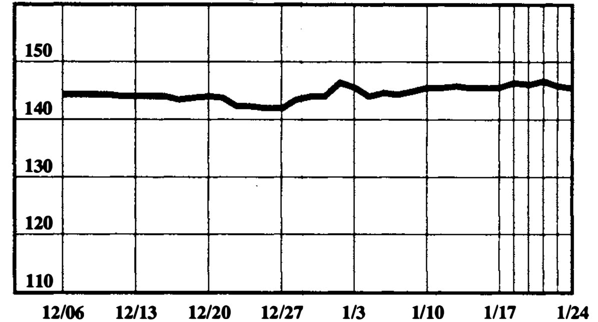

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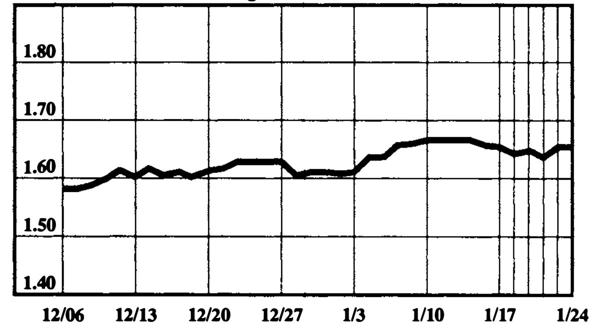

The dollar in Swiss franks

New York late afternoon fixing