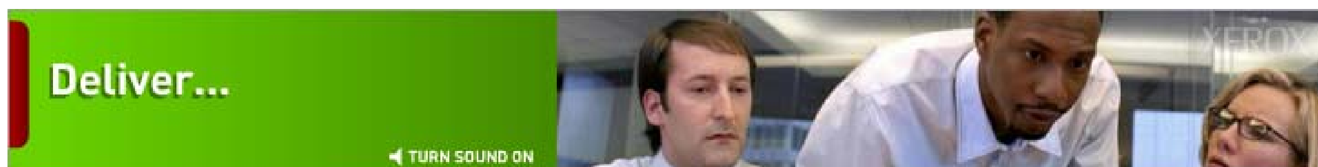

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AUGUST 13, 2007

MARKETS IN TURMOIL

By Mara Der Hovanesian

Bonfire Of The Builders

By rushing into the mortgage business big-time, homebuilders helped fuel the housing crisis

COVER STORY PODCAST

Elizabeth and Armando Motto are living a real estate nightmare with a new breed of monster: the big homebuilder as lender. In November, 2005, the couple, who have four children, agreed to pay $540,000 for a newly built three-bedroom house in suburban Clarksburg, Md., near Washington, D.C. Rather than send them to a bank, the builder, Beazer Homes USA Inc. (BZH), offered to provide a mortgage itself in an arrangement of the sort that helped fuel the long housing boom across the country.

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But when it appeared that the Mottos might not qualify financially for the loan, things took a troubling turn. Beazer, according to the couple, inflated the pair's earnings in loan-application documents by incorrectly stating they were collecting rental income from the house they were leaving. "I don't want to misrepresent myself," Elizabeth said in e-mail correspondence with Beazer's outside mortgage service, dated July 14, 2006. But in the end, the couple signed the documents, and soon after they closed on the Clarksburg house.

They now regret it. The Mottos moved to Clarksburg, but they haven't succeeded in unloading their previous home in Rockville, Md. They have nearly $1 million in mortgage debt on the two dwellings. With $145,000 in family income, Elizabeth says, they are "on the brink of foreclosure" on both houses. "We are so broke."

Beazer, one of the dozen or so large publicly traded builders that have started or stepped up mortgage-lending businesses to put more buyers in freshly finished houses, declines to discuss specific customers. The Atlanta company has much more than the Mottos to worry about. On Aug. 1 its stock fell nearly 18% on rumors that it was preparing to file for Chapter 11 bankruptcy court protection—which Beazer swiftly denied, calling the Wall Street gossip "scurrilous and unfounded." Just five days earlier, Beazer revealed that the Securities & Exchange Commission had elevated an informal inquiry into its mortgage business to a formal investigation. The company warned that criminal penalties could follow. Earlier this year, Beazer received a subpoena from the Justice Dept. seeking documents related to its home loans, and the company is also under civil investigation by the North Carolina Attorney General's office.

Leslie H. Kratcoski, Beazer's vice-president for investor relations and corporate communications, says in an e-mail that the company "intends to continue to fully cooperate with all related inquiries but does not have further comment at this time."

EGGED ON BY WALL STREET

A diverse cast of characters combined to launch the once-in-a-lifetime housing boom of the past five years. Traditional mortgage companies and banks unleashed a barrage of loans, many to borrowers with iffy credit histories who didn't bother to read the fine print about upwardly mobile interest rates. Wall Street egged on the often-reckless underwriting by buying vast quantities of home loans for repackaging as securities. Now that the boom has fizzled and foreclosure rates are rising, the important role of large homebuilders as lenders is also coming into sharper focus.

In addition to spitting out subdivisions, many of which now stand half-empty, builders jumped into the mortgage business to a degree they never had. Wall Street provided the same encouragement it offered other lenders. Even as the housing supply began to exceed demand last year, builders kept sales brisk by pushing adjustable-rate, interest-only, and other risky loans. In some cases they attracted clientele who couldn't afford conventional mortgages. In others, builders allegedly violated federal lending standards to get customers to sign on the dotted line. KB Home (KBH) paid a record $3.2 million settlement in July, 2005, to resolve allegations by the Housing & Urban Development Dept. that the builder's mortgage unit overstated borrowers' income, among other practices, to obtain loan approvals. KB, which denied wrongdoing, sold its loan business before settling.

"Homebuilders really started to push these more aggressive mortgages down the throats of potential buyers to boost sales," says G.

Hunter Haas IV, who as head of mortgage research and trading for Opteum Financial Services (**OPX**) had an insider's perspective on the proceedings. Opteum has served as a middleman between Wall Street and builders. The Paramus (N.J.) firm provided developers with financing for their mortgage operations, then resold the loans to investment banks, which packaged them as securities and hawked them to hedge funds and insurance companies. The whole process added liquidity to the market and made it easier for developers to build and sell expansively.

But by early this year, Opteum's home-loan business was going sour. The investment banks and their clients were rejecting builder-originated loans as too shaky and likely to go into default, Haas explains. Some homes were turning out to be worth less than builders had claimed, and some borrowers didn't have the income noted on applications. "Homebuilders were getting sloppy, and Wall Street was giving more scrutiny," Haas says. In June, Opteum decided to get out of home-loan brokering.

Until the market turned, the growing heft of the largest developers made it easier for them to obtain Wall Street financing for their mortgage businesses. Once dominated by modest local firms, the industry in the past two decades has seen the emergence of sizable publicly traded corporations such as Pulte Homes (**PHM**), Lennar, and Centex (**CTX**), each of which has a market capitalization of $7.5 billion to $8.5 billion. The 10 largest builders together had revenues of $98.8 billion last year, up from only $9.3 billion in 1992. Public companies built 27% of all new homes in 2006, compared with 8% in 1992. And in Denver, Las Vegas, and Phoenix—markets that were scorching hot until recently—public companies put up 55% or more of the new houses.

Busy developers that provided Wall Street with equity-underwriting business discovered they had friends in the investment banking world. "Once builders got larger and a little bit more predictable, they were able to borrow money from various credit markets, borrow from Wall Street, and expand more easily," says Thomas W. Smith, a building industry analyst with Standard & Poor's Equity Research, which like *BusinessWeek* is owned by The McGraw-Hill Companies.

For a while during the boom the big builders could do no wrong in Wall Street's eyes. The Dow Jones U.S. Select Home Builders Index surged 290% from October, 2002, to July, 2005, as the profits of the 10 biggest developers more than tripled. But the pressure to beat quarterly expectations didn't relent when more and more new subdivision homes remained empty. Providing loans to financially marginal buyers was one way some developers tried to prop up their financial performance, says S&P's Smith. "You're trying to support earnings at high levels, so it's conceivable that greed gets into people's minds," he adds.

Now the bust is taking a brutal toll. In January, industry analysts predicted that the 10 biggest builders would have average earnings per share of $3.69 for 2007; the latest forecast is for a loss of $1.18.

Sheer overbuilding, a symptom of every housing bubble, is the most obvious explanation for the new ghost towns sprinkled around the country. But increased builder lending helped feed the trend. Statistics are scarce because developers don't break out their lending revenues, but some analysts track "capture rates," or the percentage of home sales financed by builders themselves. Pulte Homes, the largest developer by market cap, had a capture rate of 90% last year, up from 64% in 2000, according to Daniel Oppenheim of Banc of America Securities (**BAC**). No. 3 Centex had a rate of 80% for the fiscal year that ended in March, up from 61%.

By the time marginal buyers fall behind on their payments, the builder has usually sold off their loans to Wall Street. But the human fallout can be found in neighborhoods around the country.

Several developments built recently near Columbus, Ohio, by Dominion Homes Inc. (**DHOM**), are scarred with empty houses, overgrown yards, and front windows with neon-orange foreclosure stickers. Dominion often offered "buy-down" mortgages in which it forgave or reduced early payments, according to borrowers. One young couple, Travis and Kelly Gunther, say this enticement helped persuade them to borrow all of the $180,300 they paid in 2004 for a Dominion home in a neighborhood called Williams Creek. Kelly has worked intermittently as an executive assistant; her husband, a plumber, recently went to Iraq to work for a private contractor. Kelly claims Dominion told her the couple's initial monthly payment of $1,160 would rise $100 a year, to $1,360 in 2006. In fact, the payment rose by more than $200 a month each year, to $1,599. She says Dominion salespeople described annual homeowner association fees of $50 a year that ballooned to $285, while taxes turned out to be double the company's projection.

Although she feels misled, Kelly concedes that she and Travis didn't carefully scrutinize the fine print spelling out their loan terms. "I wanted the house with the tree-lined streets," she says. Earlier this year the Gunthers lost their Dominion home in a foreclosure and are moving to a nearby rental apartment.

Adrian Lee, a firefighter in Pataskala, Ohio, is negotiating to avoid foreclosure on the new four-bedroom house he bought from Dominion in 2004. "I know I'm in too much house for what I can afford," he says. Admitting that he shares blame for his predicament, Lee says of the Dominion sales team: "They didn't explain the [$163,800] loan to me. I didn't know after the buy-down mortgage that my payment would be so high. The same people who help you get a home won't help you maintain and keep it."

THE FORECLOSURE NEXT DOOR

Lori M. Steiner, a senior vice-president with Dominion, says in an e-mail that the Dublin (Ohio) company doesn't discuss individual customers. But Dominion says it diligently reviews each sale to make sure buyers are financially prepared to take on the mortgages they seek. The company says it has done extensive research in the Columbus area and that the spike in foreclosures there reflects broader economic problems that have nothing to do with its financing business. Ohio, hurt by a loss of manufacturing jobs, has one of the highest foreclosure rates in the nation, along with California, Florida, Michigan, and Texas.

Even some home buyers who are content with their loans claim they've been injured by builders' lending to others. Robert V. Phillips, a lawyer in Rock Hill, S.C., represents residents of a subdivision in Columbia, S.C., who allege in a federal court suit that the value of their homes has fallen as a result of foreclosures stemming from Beazer's reckless mortgage practices with other customers. The suit, which seeks class-action status, claims that Beazer salespeople encouraged prospective buyers to "falsify information on loan applications." This made it "inevitable that the subdivisions...would experience a foreclosure rate which significantly exceeds the statewide average," and that has hurt the value of the plaintiffs' houses, the suit alleges.

Beazer has filed a motion to dismiss the action, noting that the plaintiffs don't claim to have been misled or directly harmed by the company. "The complaint," Beazer argues, "is based upon speculative allegations of causation and conclusory statements."

Der Hovanesian is *BusinessWeek's* banking editor

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