

## “HOW WALL STREET IS IMPACTING THE HOME IMPROVEMENT INDUSTRY”

Sub-prime mortgages. Credit crunch. Stock market volatility. Private Equity. These words have been in the news quite a bit lately, but what does it all mean? And how will these phrases and the activities on Wall Street affect the Home Improvement industry? This article will attempt to put these seemingly unrelated topics together.

1. The Housing Industry, Sub-prime Mortgages, and Wall Street. More ink has been spilled by newspapers and magazines on the topic of Sub-prime mortgages in the past three months than in the prior 30 months, most likely. “Sub-prime” mortgages and their cousin the “Alt-A” mortgages are housing industry terminology for types of mortgages that have been offered to lower quality credit borrowers, homebuyers who, by traditional standards, could not qualify for a home loan. Either the borrower’s credit scores were too low, or their income was not sufficient to obtain a loan. This changed in the mid-2000’s USA housing boom, with a lot of help from Wall Street. Credit, in the form of newer mortgage products, was extended to millions of people. To get a sense of the scope, it is estimated that of the new mortgages originated in the United States in 2006, 40% were in the Sub-prime and Alt-A category.<sup>1</sup> That means only 60% were “Prime” mortgages, which required traditional standards of income verification, above-average credit scores, and a significant down-payment (10-20% of purchase price). It reminds this observer of the period in the mid-1990’s when Sears, Roebuck & Co. flooded the marketplace with new credit cards. They offered millions of new cards to poor-quality borrowers. What happened? Merchandise sales jumped . . . and were then followed by the inevitable rise in defaults. Oops! Guess there was a reason those consumers had poor-credit scores in the first place.

How and why this great lending bonanza occurred would take pages to fully explain, but in a nutshell, the mortgage industry has changed dramatically in the last ten years. This is where Wall Street enters the picture. Not too many years ago a local bank or savings and loan lender would make a mortgage loan and

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<sup>1</sup> CFA Magazine, July-August 2007, page 40.

hold onto it for many years, thereby ensuring that their borrower was credit-worthy at the start of the loan and that Mr. or Ms. Borrower would continue to make the payments. Now, however, your local lender is about as likely to hold onto your loan as you are likely to watch television on a black and white RCA with no remote! Through a process called “securitization”, loans are now bundled together into bonds and sold to various investors around the world. It is estimated that upwards of 80% of the loan values originated during the past five years have been securitized and sold off<sup>2</sup>. Demand for loan volume increased while demand for loan quality decreased.

This housing party has been very good to the Home Improvement industry. Throughout the housing boom, defined by most observers as beginning in 2002 and running through 2006, new home construction and existing home sales were up, up, and up. All those new homes needed furnishings and all those existing home sales led to refurbishing or renovation. Increasing home prices led to increasing amounts of home equity available to homeowners, which they gratefully capitalized on. The Federal Reserve Bank estimates that over \$500 billion was “extracted” via home equity loans by US homeowners in 2005<sup>3</sup>. The total for 2003-2005 exceeded \$1.5 trillion<sup>4</sup>. That money paid for a great many things: vacations, automobiles, and home improvement projects.

Now comes the difficult part . . . cleaning up the party. With new home construction expected to be down in 2007 and 2008, and home prices declining in certain markets in the country, it is going to be a difficult 15 months for the Home Improvement Industry. Many of the company leaders that I have spoken to are really “battening down the hatches” and expect a difficult period through the end of 2008. With consumers expected to spend but at a lower rate (at best) or decline from previous levels (at worst), and home improvement retailers of all kinds still opening stores (Lowe’s and Menards), or placing renewed emphasis on core stores (Home Depot), or trying to gain market share (Ace Hardware, True Value, LBM’s), the future looks difficult indeed for the supplier community.

2. Credit Crises and Home Improvement. How did the process of “securitization” lead to an overbuilt housing market, which led to a credit crisis? Wall Street’s

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<sup>2</sup> CFA Magazine, July-August, Page 39

<sup>3</sup> CFA Magazine, July-August, Page 43

<sup>4</sup> CFA Magazine, July-August, Page 43

securitization of mortgage loans were bundled and sold to various institutional investors worldwide. Because assumed default rates were low, there were plenty of willing buyers who were looking for greater yield than those found in traditional US Government or Corporate bonds. Like oxygen to a fire, the process of securitization helped fuel the housing surge.

There are two major problems currently afflicting the housing market: excess supply and increasing default rates. Excess supply will take a bit of time to work itself out. Home sales are forecast to slide slightly more than 5% for 2007, after dropping 8% in 2006<sup>5</sup>. Couple that with expected real drops in home prices in the resale market, (the first drop since 1991), and you have a recipe for defaults. Which is exactly what is occurring. The default rate for Sub-prime mortgages, which accounted for 20% of all mortgages created in 2006, stood at 12.6% as of February 2007, much higher than normal, and 8 times higher than the 1.5% default rate on conventional "Prime" loans (the traditional kind)<sup>6</sup>.

The big issue for Wall Street and the credit markets has been the psychological change and the resulting late summer panic from increasing default rates and investor uncertainty regarding the bonds that were created by the packaged Sub-prime and Alt-A mortgages. In other words, the market collectively said: 'Just what are these things worth?' and no one really knew because there was no historical basis for price comparison.

Thus, there was a dangerous loop of fear, investment loss, unwillingness of banks to lend, traders to trade (what financial markets like to call a "lack of liquidity"), and a run towards safe investments such as US government securities. These were the factors behind the stock market volatility and financial freeze-up of credit as seen in July and August. This tremendous volatility, coupled with uncertainty about true mortgage loan value, led to halting of the great mid-2000's merger and acquisition boom.

3. 2000's Buyout Boom. The global merger and acquisitions boom, which began in late 2003, has now run out of steam. The boom was fueled by two primary factors: easy credit by banks and other lenders, and the growth of the private equity community.

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<sup>5</sup> Mesirow Financial, April 9, 2007

<sup>6</sup> CFA Magazine, July-August, Page 41

Plentiful credit, in the form of bank loans and successful bond offerings, was a catalyst of the recent deal boom. Investors looking for higher rates of return were eager to lend money (in the form of bond purchases) to all manner of buyers . . . and lend they did. In fact, January through June 2007, global M & A volume as measured by the total transaction values had been running at its highest annual rate ever<sup>7</sup>. And what was once an absurd thought became a near reality: the \$100 billion buyout. That's \$100 billion . . . as in one-tenth of a trillion. That was the rumor making the rounds on Wall Street this spring concerning the fate of The Home Depot. While that rumor is now just a memory, another \$100 billion deal is still in the works: the takeover/purchase/breakup of Dutch banking giant ABN Amro. The current value of that deal is \$97 billion. With two suitors in hot pursuit, you can be sure there will be one winner. The second major factor behind the recent merger wave was the prominence of the Private Equity community. Private equity firms are private partnerships that solicit institutional investors for capital. The private equity firms then buy private, or increasingly public, companies with the goal of improving their business operations and either selling them or conducting an IPO stock offering, sometime in the following three to five years. These buyouts, sometimes called leveraged buyouts (LBO's) have grown tremendously in this decade. In 2000, LBO's accounted for \$14 of every \$100 spent on merger deals in the United States. In 2007, through July, LBO's accounted for \$37 out of every \$100, an increase of 164%<sup>8</sup>.

The amount of money at the disposal of the private equity firms is truly stunning. Capital raised, globally, by private equity firms from July 1, 2006 to June 30, 2007 was almost \$500 billion<sup>9</sup>. Conservatively borrow three times that amount and the global buying power of these firms is \$2 trillion.

However, the crisis of confidence, as seen in the mortgage market that spilled over into the stock market through wild price swings, has derailed the buyout boom. The large availability of credit, and the easy terms to obtain it, had acted as a turbocharger to the private equity community. And that community acted as a rocket ship for the stock market, as the Dow Jones Industrial Average hit a record close of just over 14,000 on July 19, 2007. The financial markets were like

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<sup>7</sup> Wall Street Journal, September 6, 2007

<sup>8</sup> Wall Street Journal, September 6, 2007

<sup>9</sup> DTCF Building Products Update, Q207, Page 3

a sailboat with a giant tail wind behind it. Now the wind has shifted and we will find out how good the sailor is.

4. Near Term Outlook. What do all of these financial market factors mean for the Home Improvement industry? The Federal Reserve is attempting to firm up the financial markets and avoid letting the US economy sink into recession. On September 18<sup>th</sup>, they cut the Federal Funds Rate one-half percentage point from 5.25% to 4.75%. History will tell us whether they were igniting inflation or prudently attempting to stabilize the economy but I foresee the following factors playing out over the next 18 months:
- First, the stocks of the public industry companies will likely suffer. Leveraged buyouts will be harder and costlier to finance. Look no further than revised buyout of Home Depot Supply for evidence. When buyers couldn't obtain the needed financing (from bank loans and bond sales), they cut their offer price. And with Frank Blake in charge at HD and wanting to shed the Supply division, Home Depot accepted a lowered sale price. So, potential home improvement buyout targets will not accrue a takeover or buyout "premium" that they may have received in the past. This will be a negative for stocks of the public home improvement suppliers.
  - Second, as noted earlier, with home prices status quo at best, and consumers already having used their home equity loans to fund lifestyle purchases, I believe consumer spending will suffer. That does not bode well for suppliers or retailers in the industry.
  - Third, the homebuilding and mortgage industries will undergo a contraction. This will act as a drag on Gross Domestic Product. Exactly how much impact this will have is anyone's guess but most experts predict GDP to be hurt by 0.50% to 1.0%. This would put GNP growth at 1.0% to 1.5% for the latter half of 2007 and into 2008.
  - Fourth, the private companies in the industry, like their public counterparts, will have to wrestle with a 1) the aftermath of a housing bust, 2) slumping retail sales and 3) powerful retail customers who continue to beat up their suppliers where possible.

- Fifth, in a surprising turn of events, I believe the slowdown of the big ticket M & A market will actually increase activity for private company M & A in home improvement. I believe private equity will go back to its roots somewhat and investment firms will focus on more traditional deals: private companies looking for growth capital, or a partial or full exit plan for private shareholders or family members.
- Sixth, the weakening US dollar will see a company or government from an Emerging Markets country (like India, China, Brazil, or a Gulf State) acquire a major brand-name US Home Improvement supplier company in a billion-dollar plus transaction.

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