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Commercial
Real Estate

University of Southern California – Lusk Center for Real Estate Homebuilding Update

July 14, 2020

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Agenda

- Wells Fargo Homebuilder Banking Overview
- Current Market Update
  - What's Happened?
  - What have Builders done / What are Builders doing?
  - How has the housing market survived?
  - Builder Updates
  - What are Banks doing?
  - What's temporary and what's here to stay?
- Q&A

Homebuilder Banking Overview

Pursue an advisory and "lead bank" orientation with our clients by combining industry expertise, homebuilder corporate finance insight, real estate project lending skills and an expansive product suite in order to share ideas, alternatives and solutions.

- **Mission:** To be a trusted advisor and leading capital provider to high-quality regional and national homebuilders and land development firms. We will endeavor to be market and industry experts and deliver the benefits of
  Wells Fargo's entire platform of relevant products and services to the customer, in order to help our clients meet their financial goals.
- **Products:** Builder Lines of Credit, Project A,D&C financing, Borrowing Base, Loan Syndications*, Public Debt & Equity*, Treasury Management, Interest Rate Risk Management*
- **Our target clients include:**
  - Local and regional builders with standing and scale to benefit from the Wells Fargo Homebuilder Banking Group's balance sheet and platform of relevant products and services.
  - Real estate developers with cycle-tested balance sheets to support their respective levels of land development and construction risk.
  - Public builders and institutional profile sponsors with complex capital structures.
  - Individual funds and financial sponsors with history and scale to support the development risk.

Clients – Profile & Target

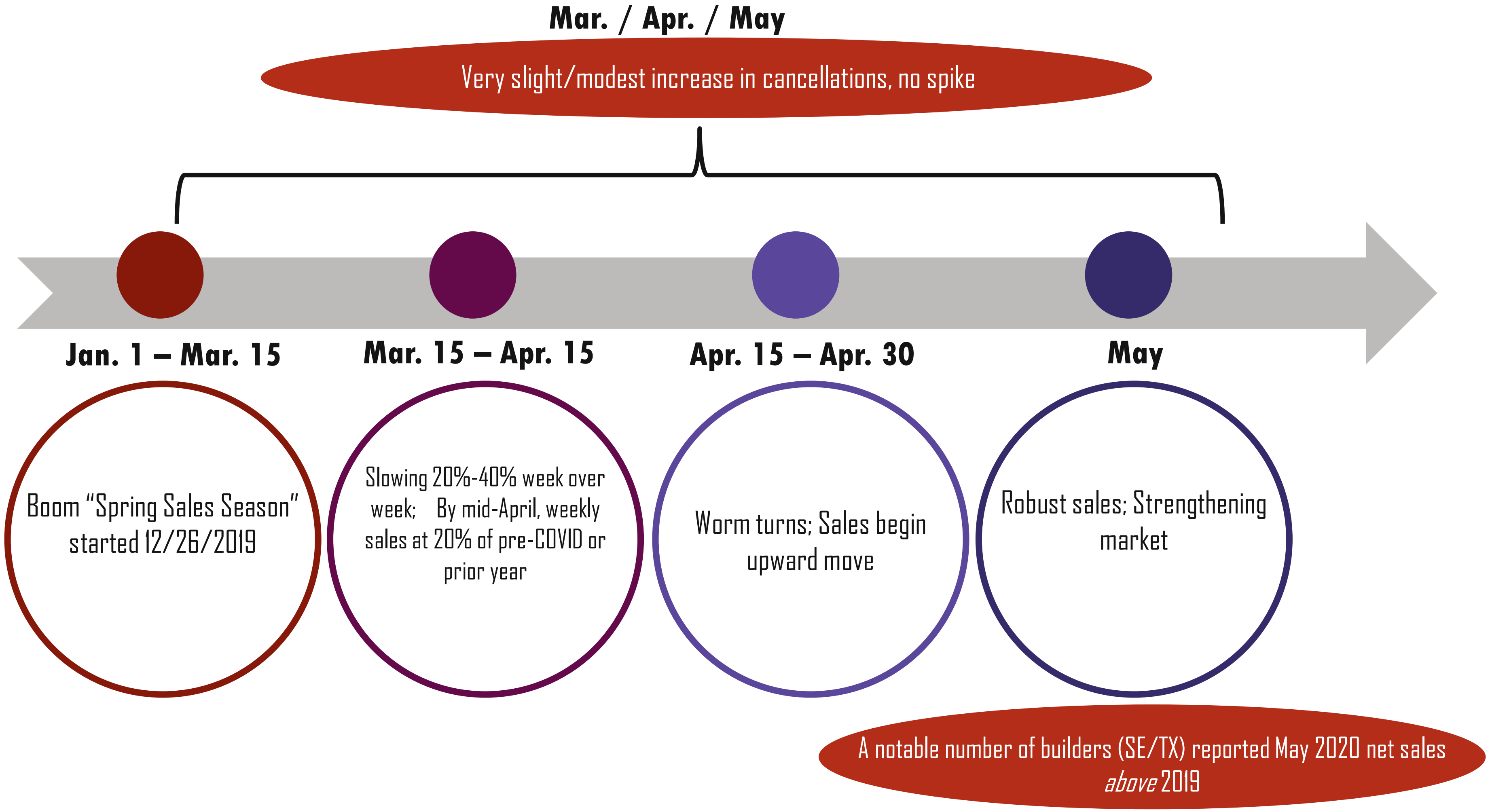
- **Market Share:** Based on the May 2019 Builder Top 100, our team currently has a Core lending and/or Tier One Relationship with:
  - 14 of the Top 25 (56%),
  - 24 of the Top 50 (48%), and
  - 43 of the Top 100 (43%)
- Our target client, generally speaking, is a Top 200 US homebuilder, defined as, at a minimum, someone that builds 200-300 houses annually and has a debt capacity of $15MM or more. These can be local, regional, or national builders.

Representative Clients:

Current Market Updates

What's Happened?

What’s Happened?



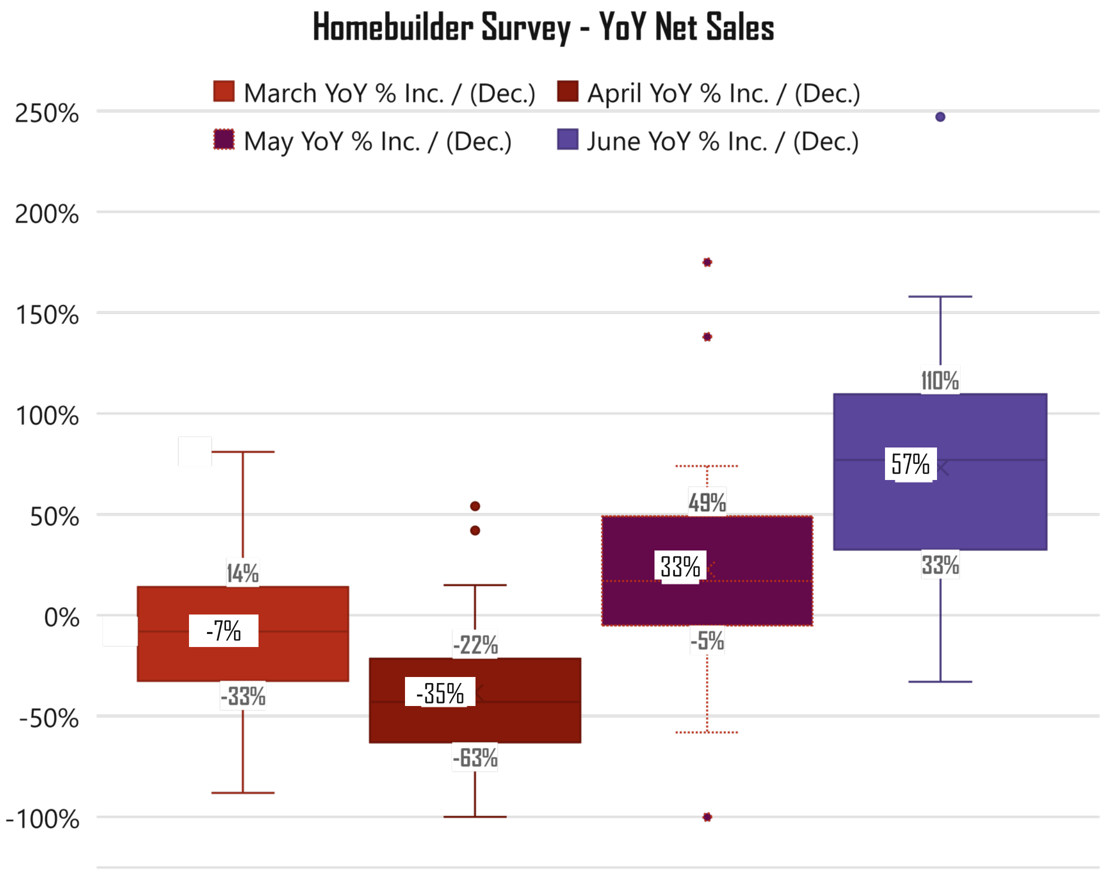
Some Better: Entry-level, suburban, exurban, secondary/tertiary markets, lower price points, Southeast, Texas

Some weaker: Shut down markets (NY, MI, WA, parts of CA); higher end/move-up; Active adult; Coastal California

June Survey

- Surveyed 37 regional/national builders representing +42,000 annual closings in 2019.
- Not a "statistically correct" survey –
  - Weighting indexed to SE/TX/CA vs. Midwest, NE, Rocky Mountain States, Mid-Atlantic, Pacific NW
  - Some misdiagnosis due to some medium/smaller builders having more communities open now vs. 2019 (not a "same store" sample)
  - "Net" and "gross" sales reported differently by different builders
- March – 23 of 37 builders reported a YoY decrease in sales
- April – 31 of 37 builders reported a YoY decrease in sales
- May – 12 of 37 builders reported a YoY decrease in sales
- **June – 3 of 37 builders reported a YoY decrease in sales**

Builder	2019 Closings	March YoY % Inc./(Dec.)	April YoY % Inc. / (Dec.)	May YoY % Inc. / (Dec.)	June YoY % Inc. /(Dec.)
37 Builders	42,729	(7%)	(35%)	33%	57%
(Total Annual Volume)					



Notes to chart:
- Percentages are weighted average by builder size
- Wide range ("whisker") is 75th percentile, box range is 50th percentile
- Dots outside box and whiskers are statistical outliers

June Builder Observations

Migration Patterns: Urban → Suburban Shut down is increasing urgency for urban renters to buy a home, and ability to WFH allowing buyers to consider farther out markets.

Oil & Gas not an issue to date in Houston

Minimal Cancellations & Customers setting appointments are real buyers

Increased cases not slowing traffic (yet), and supply chain remains strong

Active Adult still generally slow YoY – hard to sell amenities and connectivity right now

Renters → Buyers

Challenge: Buyers are looking for quick move-ins; difficult given curtailment of spec starts March-May

Current Builder Outlook

- ***Cautiously optimistic***
- **Monitor Risk** – Intend to continue to self-regulate lot purchases and land development; overall very limited inventory in market protects downside
- **Active Adult** – Could see activity pick up due to pent up demand from NE and Midwesterners who previously stayed home
- **Cost Increases** – Potential significant increase in lumber prices
- **COVID-19** – Unknown future impact of increasing case count

"This is the best sales market in my over 20 years in the homebuilding industry

- CFO, SE Entry-Level Builder

What have Builders done / What are Builders doing?

Priority was staying open while keeping employees and customers safe, then other obstacles could be tackled

- Focus on Safety of team, subs, clients
- Protect very strong sales backlog
- Determine / refine new construction processes (spacing, municipal inspections, supply chain)
- Determine/develop virtual processes for model showings, contract negotiations, sales, inspection, closing practices; tours via appointment only
- Refine & boost technology platforms- website, zoom, scheduling, etc.
- Defensive draws and cash build (March-April); repay fully or partially (May-June)
- Stress testing financial forecasts; impairment testing
- Stop land spend; slow development spend
- Severely curtail or halt spec starts (March-May)
- Some layoffs/overhead cuts/downsizing
- Bond market – DR Horton, NVR, TPH, Taylor Morrison
- Generating cash (closing their backlog; turning land spend/spec spend down)

How and why has the housing market survived?

Housing is tied to jobs, income rates, confidence, family formation… so WHY is housing holding up (so far) in light of +/- 15% unemployment and economic uncertainty??

According to builders, this is because, in no particular order:

- **Incredibly low mortgage rates** (and Fed actions in the mortgage market)
- **Less competition** – Very low resale inventory listings (down 20%-40%, depending on market)
- **Pent up demand** created for May/June with 4 weeks of very low sales during stay at home orders (mid-March – mid-April)
- **Social distancing** – Desire to get out of apartments or urban density for suburbs/more space
- **WFH** – Consumer belief that going forward, their employer will continue to allow significant "work from home" structure, thereby discounting problem of long commutes from suburbs/exurbs
- **New & Nice** – People are spending more time in their homes & new homes are nicer than older homes
- **Final straw** – Previous fence-sitters, "we should consider buying now maybe, huh?" from prior months are now fully incentivized to pull the trigger for some or all of the reasons listed above

"It doesn't make sense, but we're ecstatic"

"Our buyers, even at entry-levels, are generally not retail and hospitality staff profile"

Builder Updates

Builder conditions coming into 2020

- Lower leveraged
- Shorter land plays
- Lighter land
- Solid margins given limited supply
- Had been "feathering the gas pedal rather than flooring it" in 2019 due to length of cycle, slow-down of Fall/Winter 2018

Builder's mood/outlook today

- Delighted, surprised, still cautious
- Proud of their teams
- Proud of their technology platforms
- Concern that momentum will wane given high unemployment, longer term job impact
- Comforted a bit by limited inventories; no over building (this is a downside safety net)
- Noting possible "surge" or "second wave" of coronavirus

What are Banks doing?

Capital/Pricing

- Dramatic drop in rate index means dramatic drop in interest income
- While deposit cost-of-funds have fallen, equity capital charges, overhead/fixed costs, and funded public debt costs have not fallen
- Many bankers are trying to reprice and/or implement higher index (LIBOR) floors on new deals and renewals; This is important to address revenue stress
- Defensive draws and corporate/commercial deposits increase bank total assets; Ironically, this creates certain stresses in some bank reserve requirements

Hypothetical** AD&C Loan Pricing Example on Old Terms

	LIBOR	LIBOR Floor	Spread	All-In Rate
Jan-20	1.70%	0.25%	3.00%	4.70%
Jul-20	0.17%	0.25%	3.00%	3.25%
% Change	(90%)			(31%)

Credit/Structuring

- General Caution, including in homebuilding/housing despite its outperformance
  - High unemployment rate
  - Impaired incomes for many "open" industries & their employees
  - Uncertainty on length or pandemic and recession length
- Capital costs, risk adjusted return hurdles require extra 'scrub' on new credit, higher return thresholds, and more structuring overlays
- Sensitivity testing, break-even analysis, and impairment testing builder-clients income statements and balance sheets
- Inspection/draw additional surveillance
- Weekly sales monitoring
- Deep dive into loan grading and assessment

What's temporary and what's here to stay?

Temporary / Medium Term

- Incredibly low mortgage rates (& Fed actions in the mortgage market)
- Very low resale inventory listings (down 20%-40%, depending on market); less competition
- Pent up demand created for May/June with 4 weeks of very low sales (mid-Marc h-mid April)
- Demand pull-forward – previous "fence-sitters" are fully incentivized to buy now

Here to Stay

- Consumer belief that going forward, their employer will continue to allow significant WFH structure, thereby diminishing, at least to a degree, problem of long commutes from suburbs/exurbs
- Less critical to be located immediately near services – Online shopping, grocery delivery, more saving money, cooking, etc.

Unclear....

- Desire to get out of apartment or urban density for suburbs/more space
- Will the trendy trend of 2012-2019 for infill/surban, walkability, services, come back?

Q&A

- For more information on Commercial Real Estate opportunities at Wells Fargo, visit https://www.wellsfargo.com/com/financing/real-estate/?linkLoc=fn

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Thank you