
Profit & Loss STATEMENTS

A Sound Profit & Loss Statement Helps Prepare You For a Changing Loan Market

Borrowing money won't be as easy in the 1990s as it was in the 1980s. Even without tough, new rules governing savings and loans (S&Ls), lenders will be slower to lend money for real estate development, especially where risk seems high.

More than ever, lenders will want borrowers who are on solid financial ground, borrowers who can demonstrate consistent performance. They'll probably want more equity participation from the borrower too. Not all institutions will be willing—or able—to lend for all purposes. That's largely the result of the billions of dollars in bad loans that plagued lenders in the 1980s. These bad loans led to the closing or consolidation of hundreds of S&Ls.

For instance, acquisition and development money will be harder to come by, especially at the 100% levels some builders depended on. No longer will a bank or S&L be able to lend you 100% of the money to acquire lots, improve them, and then build on them as you go along, all for a share of the profits when you sell. Even if you've done this with your S&L a dozen times, new laws prohibit such joint ventures.

The sources of funds are changing too. If you as a builder are not creative and willing to go out and seek new sources of funds and look at different options, then you're going to be in trouble. This will especially affect builders who want to move into development.

Among the alternative sources of funds you'll have to seek are real estate investment trusts, syndicators, and private pension fund advisers. Even small borrowers who lack equity may have to seek out small investment groups with

whom they can form joint ventures to secure traditional borrowing. Investors and non-traditional lenders who are unfamiliar with real estate and development will be very particular about what they want in terms of balance sheets and financial statements.

You'll have to have a good track record, and you'll have to be able to show what that record is. That's where a good profit and loss statement (P&L) comes in (see "A Model Profit & Loss Statement," next page).

The Smaller Builder

The good news for small builders is that you'll probably have less trouble in the '90s than the bigger builders who rely on heavy borrowing. Even 300- to 500-unit-per-year operations are running short of funds. Their lenders had them on three-year rollovers, and now banking rules won't allow them to roll over those existing notes.

So, if you're building only 10 to 25 homes per year, all you really need to do is come up with the necessary equity and present yourself as a good risk. A good P&L statement can do both. It can help you raise money for investors if you lack equity, and it can help you get loan approval. Your P&L statement should show that your company has expenses including overhead, under control, and it should project a gross profit of at least 15% before you start each home.

As a small builder, many things are in your favor. You've probably been working on a personal line of credit with your lender, and you'll continue to do so. You're probably not heavily leveraged for a lot of land. That's in your favor, since long-term capital

loans for buying and phasing in land will be scarce. Preselling also helps. It carries less risk and improves cash flow.

Net Worth and How to Bolster It

When looking at your total balance sheet, make sure your assets exceed liabilities. You don't want to be upside down.

If you're low on this, try to reduce some of your fixed assets, which should not exceed 20% to 25% of your total worth. Consider leasing rather than owning some equipment, or using outside contractors. For instance, if you're carrying concrete equipment and its carrying costs and liabilities are prohibitively expensive, then sub out more concrete work. Even framing crews can be subbed out. This makes you a little leaner and lowers your carrying costs for equipment.

Here are some items to watch:

Marketing and sales. We like to recommend that this be 6% to 8% of your total budget. If you're spending less than this and the market slows down—last year, it did in many places—you may want to expand your marketing effort. That may include going to more market-driven designs and advertising, which are things the big builders are using. Marketing is a self-liquidating cost (called so because the more effective you are at marketing, the less you'll spend). Compare that to carrying costs; it's common sense that if you can liquidate quicker, you'll save.

Your sales office should create a proper selling environment without going overboard. It should be based on the size of your operation. Take a long, hard look at exactly what increase in sales and profitability you can expect, and

by Bob Emrick

A Model Profit & Loss Statement

With rules for loans changing in the 1990s, make sure your profit and loss statement reflects the things lenders—and investors—want to see. A good P&L statement will show what your track record has been and give potential investors an indication of where you are likely to go in the future. Here is an example of what a good P&L statement should include.

Income:		Federal Unemployment,	
Sales		FICA	\$ _____
(less cost of goods sold) \$	_____	Interest	\$ _____
Construction Income	\$ _____	Insurance, General	\$ _____
Rental Income	\$ _____	Officer's Life Insurance	\$ _____
Miscellaneous Income	\$ _____	Salaries	\$ _____
		Taxes, Licenses	\$ _____
Total Income:	\$ _____	Utilities	\$ _____
		Rental Property Expense	
Expenses:		(including interest)	\$ _____
Advertising	\$ _____	Meetings/Seminars	\$ _____
Auto Expense	\$ _____	Office Expense	\$ _____
Business Promotion	\$ _____	Telephone	\$ _____
Accounting/Legal	\$ _____	Depreciation	\$ _____
Banking Service Charges	\$ _____	Commissions	\$ _____
Repaid to Sold Houses	\$ _____	Office Rental Expense	\$ _____
Dues/Subscriptions	\$ _____	Signs	\$ _____
Plans/Prints	\$ _____	Mobile Telephone	\$ _____
		Fines and Penalties	\$ _____
		Total Expenses	\$ _____

compare it to how expensive it is to run your office.

There are certain markets where people will expect to see a fully furnished model home with brochures and a sales associate waiting at the door to take them through. If that's the case, your cost of sales will be much higher. There are many more markets, though, where it's difficult to find an ongoing, up-and-operating model, let alone a sales office. In that case, 75% to 90% of sales are done through a broker. Remember, when you work through the broker, he's picking up part of the cost of maintaining that sales office at any site.

An investor wanted to know why a builder's 1987 G&A costs were 25% higher than in 1988 and 1986. Well, the builder had bought a couple of extra trucks for his supervisors as a bonus and slugged it as an administrative cost.

Administrative cost. Things start getting out of hand when your general and administrative costs (G&A) fluctuate wildly. In one case we know of, an investor wanted to know why in 1987, G&A costs were 25% higher than in 1988 and 1986. Basically, the builder had bought a couple of extra trucks for his supervisors as a bonus and slugged it as an administrative cost. You may be used to being loose with how you spend your money, but investors won't be. Institutional lenders and investors new to building are interested in rates of return and consistency of earnings. Be prepared for that.

Consistency. Lenders—and investors, even more so—like to see consistency. If you're looking at one line item in your P&L statement that's supposed to be 15%, and you've got 14%, that's not a

big difference. It's within 10% of what was expected. But if you show a 15% to 19% jump in one year, there will be skepticism as to why these costs have not been controlled. If costs haven't been consistent from year to year, investors will guess they won't be in the future, either.

Land inventory. Your land inventory should probably not exceed 18 months. Lenders may question a company that increases starts from 25 to 50 homes a year solely to reduce land inventory. You may have to sell some of the land. Consider holding options on the land instead of buying it outright.

Put together a joint venture with the landowner for costs of lots three to five years ahead of time, without having to put any money up front. You say, "I will agree to build houses in five years. I want first right of refusal on the land. I agree to pay you 25% of the selling price of any house based on the market at that time, plus an equity kicker."

That way, it's phased in so that the landowner is not at risk. That benefits him. But you don't tie up any money, either—in reality or on your balance sheet. You'll hold down how much land you have to buy.

Profit margin. When you're trying to attract equity investors, you can't function on a 10% gross profit margin. Big investments bring higher returns in many other places. Your profit margin is going to have to be considerably higher; and your deal has to be more attractive to investors. But be careful: In most single-family construction, there's not enough margin in the land and hard costs to attract investors.

While local conditions and business practices may vary, generally accepted accounting procedures (also called GAP) are recognized throughout the U.S. NAHB has many accounting software packages approved for small builders. ■

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