Construction Lending News

Volume 14, First Quarter 2006

The Outlook for the Economy and the Housing and Mortgage Markets

By Orawin Velz[1] and Doug Duncan[2]

Outlook for Economic Growth

We expect economic growth to bounce back in the first quarter of 2006 and remain solid for the first half of this year, boosted by a rebound in consumption spending as well as by rebuilding efforts in the Gulf region.

The weakness in economic activity experienced in the fourth quarter should only be temporary. We believe that special one-time factors were largely responsible for the anemic growth: the hurricanes that disrupted domestic energy production; the unexpected decline in defense spending; the surge in petroleum imports; and the weak auto sales and productions following incentive-boosted sales earlier in the year.

Consumers have been spending more than they earn, thanks to large gains in wealth, especially from unusually strong home price appreciation, allowing homeowners to extract a significant amount of home equity, boosting consumption spending. The saving rate has been negative for seven consecutive months since June but is trending higher after hitting an all-time low in August. Continued increases in interest rates as well as an expected moderation in home price appreciation should decrease home equity extraction, further dampening consumer spending growth. Although gasoline prices have receded somewhat from their high immediately after the hurricanes, high energy prices present a risk for consumer spending.

Economic growth should slow to below-trend growth in the second half of next year when expenditures for rebuilding in the storm-damaged regions wane *(see Figure 1)* and consumption spending growth starts to slow. Economic growth will continue to be healthy, however, as growth

continued on page 2

Missouri Mechanics' Lien Law

By Thomas J. Fritzlen, Jr.[3] and Shawn T. Briner[4]

The Missouri Mechanics' Lien Act, Mo.Rev.Stat. § 429.010, et seq., sets forth the procedure by which a claim for mechanics' lien can be perfected and enforced against Missouri realty. While seemingly straightforward, Missouri's mechanics' lien laws contain hidden pitfalls for contractors, property owners, and lenders not familiar with their intricacies.

Liens Aren't Available for All Labor and Materials

While mechanics' liens are available for many forms of labor and materials so long as they were actually used or consumed in the construction of improvements, there are several key exceptions. First, mechanics' liens are not available to secure labor and materials used in public projects. In addition, mechanics' liens are not awarded for items of personalty unless they are fixtures, meaning (1) they are annexed to the realty, (2) they have been adapted for the use to which the realty is devoted, and (3) they are intended to be permanent additions to the realty.

Special Notice Required of Certain Contractors

Missouri law distinguishes between an original contractor, which is someone who contracts directly with a property owner, and everyone else who provides labor or materials for a project, referred to as subcontractors. As a condition precedent to obtaining a mechanics' lien, an original contractor must provide a specific statutory notice (1) when the contract is executed, (2) when the materials are delivered, (3) when the work commences, or (4) along with the first invoice.

The ramifications of failing to provide this notice are twofold. First, the original contractor will not be entitled to assert a mechanics' lien. Second, the original contractor could be subject to prosecution for a class B misdemeanor if its failure to provide the notice was committed with the intent of defrauding the property owner. The one exception to this requirement is that the notice need not be provided

continued on page 4

[1]Orawin Velz is a director of economic forecasting at MBA. She is responsible for producing forecasts of the economy and the housing and mortgage markets. Prior to joining the MBA, she was a senior economist at Fannie Mae and a managing director at the National Association of Realtors. Orawin received her Ph.D. in Economics from the University of Connecticut.

[2]Doug Duncan is Senior Vice President/Chief Economist at the Mortgage Bankers Association (MBA). He is responsible for providing economic policy analysis services in the areas of real estate finance, legislative and regulatory proposals and industry trends for MBA and its members. Prior to joining MBA, Doug served as a LEGIS fellow in the U.S. House of Representatives Committee on Banking, Finance, and Urban Affairs. Doug received his doctorate from Texas A & M University.

[3]Thomas J. Fritzlen, Jr. is a shareholder in Martin, Leigh, Laws & Fritzlen, P.C. and practices in its Kansas City, Missouri office. He is licensed in both Missouri and Kansas and focuses primarily on matters involving construction, real estate, fidelity and surety law, real estate commercial transactions and litigation. He can be reached at tjf@mllfpc.com

[4]Shawn T. Briner is an associate with Martin, Leigh, Laws & Fritzlen, P.C. and manages its St. Louis, Missouri office. He is licensed in Missouri, Illinois, and Kansas and focuses his practice on matters relating to real estate, banking, construction, bankruptcy, and complex business and commercial disputes. He can be reached at stb@mllfpc.com.

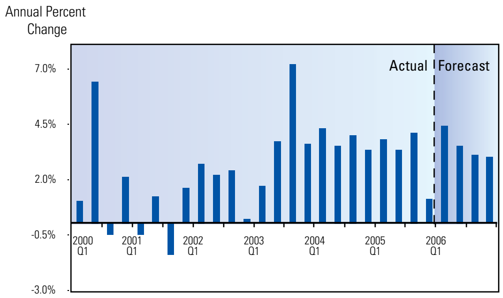
The Outlook for the Economy and the Housing and Mortgage Markets

(cont'd)

in business investment should pick up to offset slowing consumption growth. We project that real gross domestic product (GDP) growth will be at the long-run trend pace of growth this year, about 3.5 percent.

Figure 1

Real Gross Domestic Product



Source: Bureau of Economic Analysis, MBA Forecast

The Labor Markets Will Remain Solid

Job gains over the past year averaged a respectable 175,000 per month. Over the past three months, average monthly gains accelerated to 225,000, providing strong momentum going into this year. Going forward, positive economic indicators — including expanding manufacturing activity, low inventories and receding energy prices — point to a continued strong labor market. The unemployment rate should hover around 4.9 percent through most of 2006 but should gradually rise at the end of 2006 to reflect below-trend economic growth in the second half of the year.

The Fed Will Continue to Raise Rates

Following the hurricanes, inflationary pressures have become more of a concern. Although core inflation continues to be contained, it is still hovering near the upper-end of the Fed's comfort zone consistent with price stability. For example, the personal consumption expenditure deflator (PCE) excluding food and energy items — the Fed's preferred measure of inflation — increased by 1.9 percent through the second half of 2005, near the 2.0 percent upper-end of the Fed's zone.

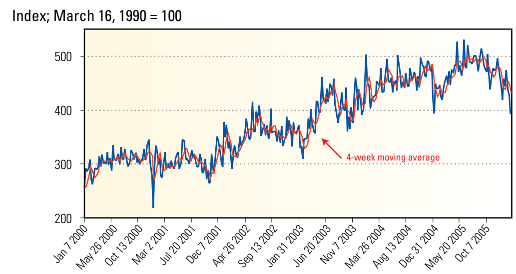
Strong employment growth in a tight labor market is a concern for the Fed as wage pressures could be building. The January payroll report showed that average hourly earnings increased by a strong 3.3 percent from a year ago — the strongest pace of growth since early 2003. We expect the Federal Open Market Committee (FOMC) to increase the federal funds rate to 4.75 percent by March. Any additional increase will depend on incoming data. Long-term rates should increase only modestly, with the yield on 10-year Treasuries rising to 4.8 percent by the end of the year.

The Housing Market Will Cool

Both new and existing home sales set a fifth consecutive record last year. The housing market appears to have peaked late last year, however, according to several leading indicators of housing activity. In particular, mortgage applications for home purchases have trended down and housing inventories have increased. The Mortgage Bankers Association purchase application index has trended down in the past several months. The four-week moving average in the index, which removes week-to-week volatility, fell in mid-February to its lowest level since last February *(see Figure 2)*.

Figure 2

Purchase Application Index



Source: Mortgage Bankers Association

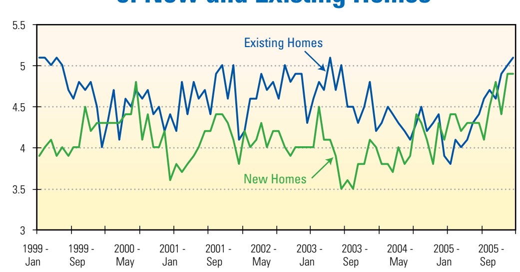
The level of purchase applications is still strong, however, suggesting that the decline in home sales in the coming months should be modest. With mortgage rates projected to increase to about 6.5 percent by the end of the year, home sales should decline by about 5 percent for the year.

Leading indicators for home building activity suggest that home building will likely trend down moderately in the coming months. After holding up better than expected in the two months following Hurricane Katrina, home builders' optimism dropped sharply in November to the lowest level since May 2003 and held at that level, according to the National Association of Home Builders Housing Market Index. The stabilization in the index suggests that the housing market should cool somewhat. We expect residential construction to decline by about 5 percent in 2006, as reconstruction efforts should help support homebuilding activities in the Gulf region.

Housing inventories continue to build for both new and existing homes, with the months supply (inventory/sales ratio) increasing significantly over the past year *(see Figure 3)*. The

Figure 3

Months Supply (Inventory/Sales Ratio) of New and Existing Homes



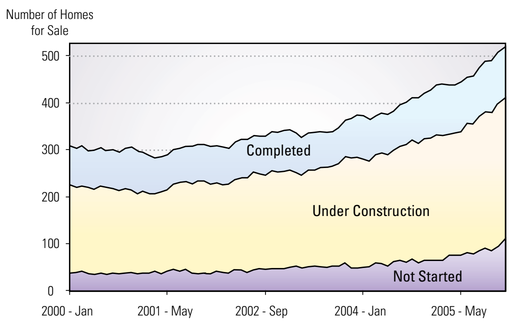
Source: Bureau of the Census and the National Association of Realtors

months supply for total existing home sales increased to 5.1 months in December — the highest level since April 2003. The number of existing homes for sale increased by 26.3 percent in December relative to a year ago. Condo inventories have accumulated much more than single-family homes, rising by 66.4 percent from a year ago, with the months supply increasing to 6.2 months from only 3.9 months a year ago.

The months supply of new homes remained at 4.9 months in December — the highest reading since December 1996. Builder pipelines also continue breaking new records, with the number of homes available for sale standing at 518,000 in December. These inventories pose a downside risk for the housing market if demand were to pull back sharply. The current situation is not alarming for new homes, however, as the structure of inventory is still healthy. Over 20 percent of new homes for sale in December are units that have permits but have not yet been started — a record-high share *(see Figure 4)*. This could be either because banks are more reluctant to finance spec construction or because builders have exercised caution. Regardless, this implies that builders could pull out a large portion of the increase in inventory if demand were to soften.

Figure 4

New Homes Available for Sale



Source: Bureau of the Census

With the projected modest decline in home sales in 2006, home price gains are projected to moderate next year from the very rapid and likely unsustainable pace of the past several years. With Katrina expected to put upward pressure on construction material costs, home price gains should remain healthy at about 5 to 6 percent next year — moderating slightly from 7.4 percent, the increase in the median price for all of 2005. For existing homes, we expect the median price gain to slow to about 6 to 7 percent this year — about half the pace experienced last year.

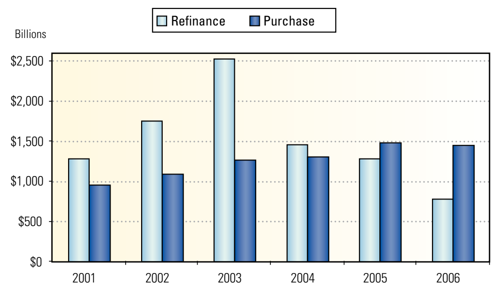
Refis Will Continue to Decline but Purchase Originations Should Remain Strong

Mortgage rates have come off their lows and refinancing activity is now fading. The MBA refi index has trended down from its recent peak in early June. As mortgage rates are projected to continue to rise through the rest of the year, refinancing activity, as well as the subsequent lift to spending, is expected to dwindle by the second half of 2006. The cash-out refi share should remain high or even increase as mortgage rates continue to increase, as more homeowners choose to refinance to liquefy equity rather than to reduce monthly mortgage payments. Cash-out refis are more attractive than home equity loans and lines of credit during an environment of rising short-term interest rates. Going forward, we expect a lower level of home equity borrowing, as higher interest rates dampen demand for mortgage refinancing and home equity loans and lines of credit.

With only a modest projected decline in home sales in 2006 and still-healthy home price appreciation, purchase originations should decline only modestly this year but refi originations should drop off significantly. We expect total originations to decline by about 20 percent to $2.24 trillion, with refi originations declining by about 40 percent to $784 billion and purchase originations declining by 2 percent to $1.46 trillion *(see Figure 5)*.

Figure 5

Single-Family Mortgage Originations



Source: Mortgage Bankers Association

Overall Credit Quality Should Remain Healthy with a Modest Rise in Delinquencies

Continued job gains and rising wages should be a positive for household balance sheets. If interest rates rise gradually and housing activity declines modestly as we expect, credit quality should remain solid. However, many factors appear to be putting upward pressure on delinquency rates in the near term. First, the large cohort of loans originated in the 2002–2003 refi wave is reaching the peak delinquency period. Second, rising short-term rates are putting pressure on ARM borrowers. Third, the share of the market comprised of subprime loans has been growing significantly in the past several years. Finally, energy prices (especially natural gas and home heating oil prices) are expected to remain elevated this year. Thus, it is reasonable to expect somewhat higher delinquency rates over the next several quarters. Countering this is our expectation for strong economic growth and continued strength in the labor market. In general, however, consumer credit quality should remain healthy this year.

Orawin Velz

Doug Duncan

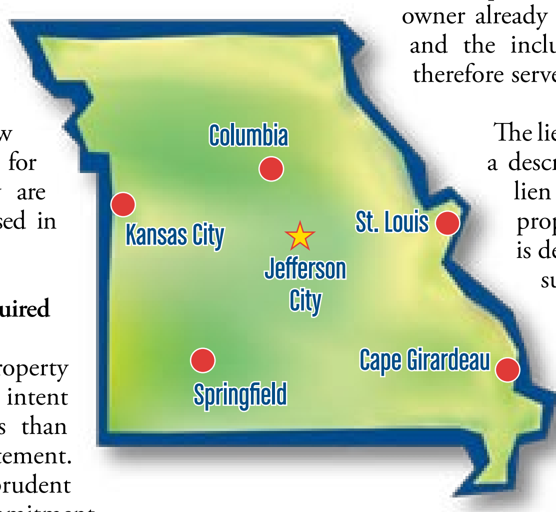
Missouri Mechanics' Lien Law

(cont'd)

if the improvement being constructed is a new residence and the buyer has received mechanics' lien coverage from a registered title insurance company.

Owner's Consent Required Under Certain Circumstances

A subcontractor is not entitled to assert a mechanics' lien for improvements to owner-occupied residential property consisting of four units or less unless the property owner has executed a statutory consent agreement acknowledging that it will be liable for unpaid items. An original contractor need not obtain consent. The purpose behind this law is to provide additional protection for property owners by ensuring they are aware that subcontractors will be used in their projects.



10-day Notice of Lien Is Always Required of Subcontractors

A subcontractor must serve the property owner with written notice of its intent to seek a mechanics' lien no less than ten days before it files its lien statement. Personal service is required. The prudent subcontractor will obtain a title commitment to determine the correct name of the owner and to see if ownership has changed since the work began. The ten-day notice should be served on both the former owner and the current owner if the property has been sold since the work commenced or the materials were first provided. The subcontractor should also serve both a husband and a wife if the realty is owned in both their names.

The purpose of the ten-day notice is to provide the property owner with an opportunity to withhold payment from the original contractor and avoid "paying twice" for labor and materials.

Proper Lien Statement Must Be Timely Filed With Circuit Clerk

A mechanics' lien claimant must file a lien statement with the circuit clerk for the county in which the realty is located. The lien statement must be filed no later than six months after the date on which labor or materials were last provided. In determining the last day of work, repair and warranty work is excluded and cannot be relied upon to extend the deadline for filing a lien statement. The six-month deadline for filing a lien statement must be carefully calculated and monitored and subcontractors need to ensure sufficient time exists to permit service of the ten-day notice.

The lien statement must contain a "just and true account" of what is owed to the claimant after all credits have been applied. The underlying purpose of this requirement is to provide the property owner with the means of identifying the items for which a mechanics' lien is sought, verifying whether they were actually provided, and confirming whether or not payment has been made. The practical effect of this requirement is that contractors are obligated to attach to their lien statement as much information and documentation as possible, including dates on which work was performed, dates on which materials were delivered, and descriptions of all work and materials provided and the charges for both. An original contractor with a lump-sum contract is excluded from this requirement, the reason being that the property owner already knows what items were to be provided and the inclusion of a detailed description would therefore serve no additional purpose.

The lien statement must be verified and contain a description of the property against which a lien is sought, the claimant's name, and the property owner's name. A lien statement that is defective in any of these regards cannot be successfully amended once the six-month filing deadline has expired.

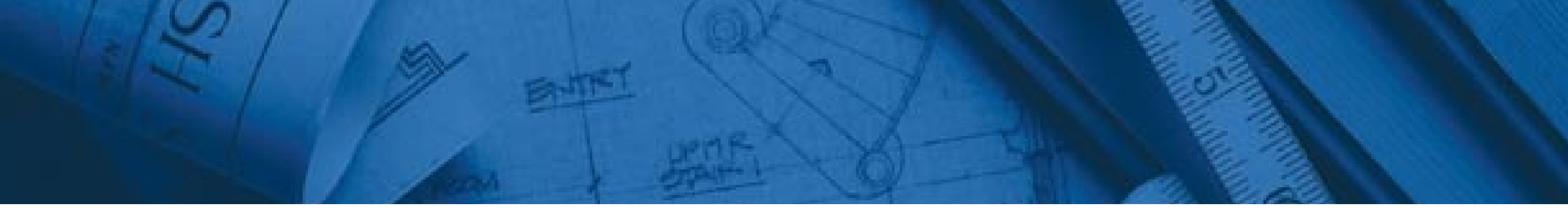
Enforcement Actions Must Be Promptly Filed and Intervention May Be Required

A mechanics' lien claimant must file suit to enforce its mechanics' lien no later than six months after its lien statement was filed. Missouri's ordinary rules regarding pleadings and procedures apply to enforcement actions. If a separate enforcement action has already been initiated against the same realty, the mechanics' lien claimant must intervene in the pending proceeding. When more than one claim for mechanics' lien are joined together the action is characterized as equitable in nature and operates to stay all other proceedings for mechanics' liens against the realty.

While the Missouri Mechanics' Lien Act does not provide for recovery of legal fees or costs, some contractors have adopted the practice of requesting them pursuant to Mo.Rev. Stat. § 431.180, which also provides for pre-judgment interest at the rate of 18% per annum. The specter of interest and attorneys' fees impacts settlement negotiations between contractors, property owners, and lenders.

Lien Has Priority Over Subsequent Encumbrances

A valid mechanics' lien is deemed to have attached to the realty on the first day of work. As such, it will have priority over any encumbrances that attached after work was commenced, including deeds of trust. This means that as between a valid mechanics' lien and a deed of trust recorded after the first day of work, the mechanics' lien will have priority with respect to both the improvements and the underlying realty.



Missouri Mechanics' Lien Law

(cont'd)

Mortgagees Can Impliedly Waive Priority of Their Security

Despite statutory provisions that expressly afford a previously-perfected deed of trust priority over a valid mechanics' lien claim, Missouri courts have established a basis under which a mortgagee will be deemed to have waived the priority of its lien. The cases in which waiver has been found all involve the mortgagee's participation in or knowledge of the project giving rise to the mechanics' lien. Specifically, waiver has been found when (1) the mortgagee had knowledge of and provided funds for the project, (2) the mortgagee had knowledge of potential liens, and (3) the mortgagee funded the purchase of the underlying realty with the intention that it be developed and admitted that it would not have done so absent plans to undertake such development.

Thomas J. Fritzlen, Jr.

In light of Missouri's willingness to award mechanics' liens priority over those mortgagees whose deeds of trust are recorded after the first day of work or who have participated in improvement projects, thorough procedures must be established in order to protect mortgagees' interests. The most important of these procedures is to diligently request and receive lien waivers in exchange for any and all funds that are disbursed in conjunction with a project.

Shawn T. Briner

Big Builders Getting Bigger

By Lew Sichelman[5]
REALTY TIMES—February 1, 2006[6]

Within the next five to seven years, a single "mega-builder" will cross the 100,000-unit-a-year threshold, believes a financial consultant who has helped create many of the nation's largest home building firms.

But that company — and other giants like it — are not likely to reach six-figure territory by growing from within, Michael Kahn of Michael P. Kahn & Associates in Ponte Vedra Beach, Fla., said at the National Association of Home Builders' annual convention in Orlando last month.

"It's very difficult to grow that large organically," said Kahn, who has a hand in arranging more than half the 150 mergers that have taken place among builders over the past 15 years.

The nation's largest builder, currently D.R. Horton, built just under 45,000 houses in 2004, according to the NAHB's figures, so it has a long way to go hit the hundred grand mark.

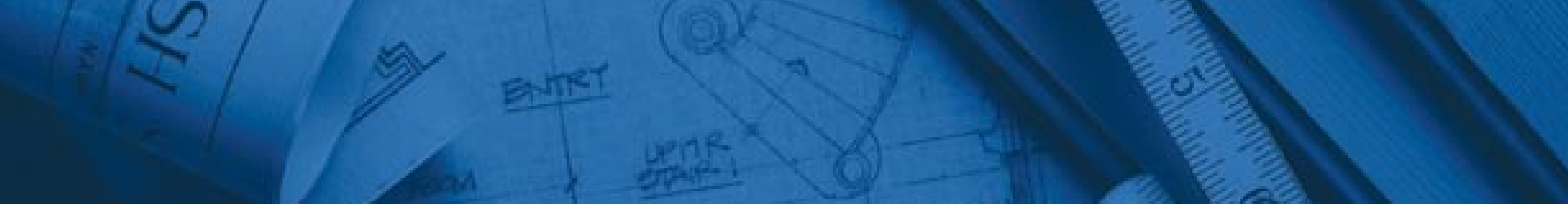
But there is no doubt that the big builder giants like Horton, Pulte, Lennar, Centex and KB, to name the top five, are controlling a larger and larger share of the market. In 2004, the last year for which full year numbers are available, the ten largest were responsible for 20 percent of all sales, according to the NAHB. And the top 100 accounted for nearly 40 percent.

A 2002 study by Anderson Corp. Finance predicted that the nation's 20 largest builders will account for 75 percent of all sales by 2011. But Gopal Ahluwalia, the builder group's staff

continued on page 6

[5]Lew Sichelman has been covering real estate from his home base in the Nation's Capital for more than 30 years. He writes a weekly consumer column that is distributed to newspapers throughout the country by United Media. He also is a regular contributor to numerous shelter magazines and housing and housing finance industry publications.

[6]Reprinted with permission from Realty Times, Feburary 1, 2006. www.realtytimes.com



Big Builders Getting Bigger

(cont'd)

vice president for research, doubted that will be the case, or that one company will produce 100,000 houses in a year's time.

At the same time, though, he expects national builders to continue to acquire "sizeable" local and regional competitors.

It's possible a one builder — or a multi-divisional company building under a single flag — could erect 100,000 houses, but only if two of one of the top five builders acquires another top five company, Ahluwalia said.

What's more likely, he said, is that within the next three years, the largest builders in the land will be building at a an annual rate of 50,000 units or more.

Although the penchant to acquire rivals began in the early 1990s in the building business, merger mania was a late starter compared to other industries, according to Kahn. But it has continued unabated.

During the first 10 months of 2004 lone, 18 deals were completed representing 12,000 houses and some 2,000 employees, according Kahn's firm. By contrast, there were only 17 acquisitions in all of 2004.

Last year's largest deals included Hovnanian Enterprises' acquisition of Town & Country Homes, which builds 2,000 houses a year in the Chicago area, and First Homebuilders of Florida, a Cape Coral-based company which had 1,800 closing in 2004. Another big transaction involved TOUSA's acquisition of another Cape Coral firm, Transeastern Properties, which built 2,300 houses in 2004.

Builders tend to buy up their competitors for several reasons. For one thing, it's easier to buy your way big than grow your way big. For another, it's easier to buy an operating entity when entering a new market than it is to start up fresh. But for the most part, it's the only way to quench the insatiable appetite for land.

While a Top Builder typically has six years worth of land in inventory, NAHB's Ahluwalia reported, Toll Brothers has more than nine years worth at the firm's current sales pace and Pulte has 8.9 years worth.

Pulte alone has 369,000 lots under its control, either owned outright or under option; Horton, 323,000; Lennar, 303,000, and Centex, 286,000, according to the NAHB.

Since 1993, Lennar has acquired 23 other companies, while Horton has nabbed 17 and KB has taken 14.

Surprisingly, perhaps, acquired companies rarely spurn their suitors, according to Kahn. Indeed, in 7 out of every 10 deals the financial consultant has worked on, the seller initiated contact.

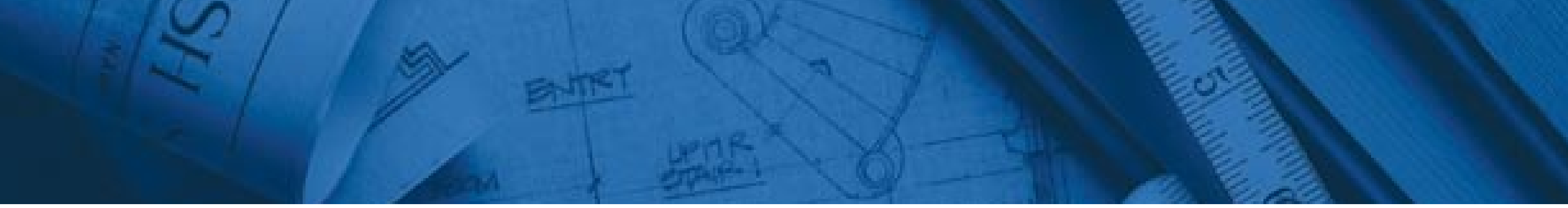
When his client is the buyer, the company is "very focused on what it is looking for" in the way of an acquisition. "They typically identify three to five builders in the marketplace they want," Kahn said, adding that he has "never missed" when it comes to locating an acquiescent seller.

"I always find someone willing to sell," he said.

Despite the penchant for merger, and the advantages that size gives big builders over the competition — their cost of capital is lower, they obtain volume discounts from suppliers and they enjoy production efficiencies that others cannot match — Ahluwalia doesn't think the days of small and mid-size builders are numbered.

"Small and medium volume builders will continue to concentrate on niche markets," he told reporters. "The overall market will continue to include a very large number of small companies."

However, according to a report by Harvard University's Joint Center for Housing Studies that was released at the convention, the top five builders have more than a 45 percent market share in Denver and Austin, and better than a 35 percent market share in Sacramento, Las Vegas and Ft. Myers, Fla.



THE RIGHT TOOL

FOR THE RIGHT JOB.

Now verifying job progress before you authorize draws is as easy as logging on to the Internet. Trained professionals from Granite Construction Inspections (GCI) visit job sites nationwide, conduct thorough walk-throughs, and post up-to-date digital photos and reports on the Web for verification within 48 hours of inspection requests. So you can be absolutely sure the work is complete before you cut the check.

Contact us today and start using *The Right Tool for The Right Job*. You'll see the difference right away.

GRANITE CONSTRUCTION INSPECTIONS

T: 1.800.919.8903
F: 1.888.647.4677
info@gcinspects.com
www.gcinspects.com

Mark Your Calendar:

"Strategies for Success in Construction Lending"

THE RITZ-CARLTON, LAGUNA NIGUEL

DANA POINT, CALIFORNIA

December 6–7, 2006

Sponsorship Opportunities Available

Inquire today at www.graniteloan.com

In This Issue:

Construction-at-a-Glance

	Dec. 04	Dec. 05
Total Monthly Housing Starts*	2,050	1,988
YTD Permits-Single Family*	1,612	1,681
Monthly New Home Sales*	1,247	1,298
Unemployment Rate	5.4%	4.9%

**Thousands of Units*

GRANITE
LOAN MANAGEMENT
10770 E. Briarwood Ave.
Suite 280
Centennial, CO 80112