Illustration 15.2
Credit as an Entry Barrier

The Wall Street Journal reported, “1991 was the worst year for housing starts since World War II. The nation’s largest builders should feel truly grateful. For when it comes to home building, this isn’t an equal opportunity recession.” Why should home builders feel grateful for a building slump? The article goes on to say, “The slump has stopped many small and mid-sized builders in their tracts, but it is allowing the better-financed large builders to improve their position…[to] grab more and more of the market.”

The recession that was under way at the time, in combination with the aging of the baby-boom generation, contributed to slowing the formation of new households, and consequently, housing starts dropped dramatically. At the time, the legacy of the savings-and-loan crisis also reduced the willingness of the banks and S&Ls to make construction loans. This particularly hurt the smaller builders who were accustomed to borrowing on a project-by-project basis. Midsized builders, the article points out, generally bought tracts, then developed them by putting in roads, sewers, and so forth, before building homes.

Many banks simply stopped making loans for such projects, often citing pressure from regulators. This reluctance to lend not only prevented many builders from starting new projects but also stopped some projects midway through development. When loans came due, banks were refusing to roll them over, forcing many builders to unload developed land at fire-sale prices.

According to the ***Journal***, “Most large builders don’t operate through project-by-project loans, and certainly don’t borrow 100 percent of needed funds, as smaller builders often must. When they can’t finance a project from cash on hand, the stronger firms may dip into a revolving credit line—which smaller builders rarely can get, lacking the track record and equity of many large publicly held firms.” These credit lines were not secured by real estate. The executive vice-president of the National Association of Homebuilders said that the big banks did not consider the credit lines real estate loans, which many were reluctant to give, but instead, corporate loans. Furthermore, a large builder was less likely to borrow from a S&L than a smaller builder, who would be in trouble if the S&L failed, the Resolution Trust Company cut off credit, and then demanded that the builder make up the difference between the loan value and the reappraisal value of the property.

In addition to any technical or marketing economies of scale that the larger builder possessed, as a housing-market analyst observed, “Financing has become a barrier to entry now for builders to do anything more than a couple of houses a year.” This story from the home-building industry graphically illustrates the way that financing, discussed briefly, can be a significant barrier to entry into the business.

Source: This illustration is based upon the article by Jim Carlton and Mitchell Pacelle, “Weak Home Market Confers an Advantage on Largest Builders,” ***The Wall Street Journal,*** January 27,1992.