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CRAWFORD DEVELOPMENT CO. AND SOUTHEAST BANK OF TEXAS

In late August 2007, Peter Kloeckner, a longtime business loan manager at Southeast Bank of Texas, was looking through a recently updated analysts' report for trends in Houston's real estate market. The new data he saw were not as gloomy as those from other regions of the country, yet they still led him to believe that a business loan he was about to approve—a three-year business loan of $38.375 million to Crawford Development Co.—would not be as profitable for the bank as he had originally thought. The loan had a *bullet structure*[1] and required a 7% annual interest rate payable at the end of the loan's life.

Crawford Development Co.

In an industry where hundreds of practitioners had made and lost fortunes, Andy Crawford stood out as one of only a handful of Texas developers who had never filed for bankruptcy. In his 30-year career, Crawford developed more than $1 billion in successful real estate projects and survived some of the worst real estate markets in America's history. Starting as a contractor in the suburbs of Houston, Texas, in 1972, he quickly grew his business and became a residential builder in 1977. By the late 1990s, he turned his company, Crawford Development Co. (CDC), into a major Texas real estate market player that had a presence in a variety of real estate assets including office buildings, industrial distribution facilities, retail shopping centers, and residential neighborhoods. Crawford had earned the title of the luckiest real estate developer in Texas, but he believed his success was due largely to the understanding of the risks associated with real estate developments.

In 2005, nearing retirement age, Crawford decided to downsize and spend more time with his wife of 35 years and their four grown children and nine grandchildren. He pooled most of the equity capital from his business and decided to work on one deal at a time. He thought that his longstanding business connections and experience would give him the upper hand in the market

[1] A loan with a bullet structure did not require any intermediate interest payments, thus principal and accumulated interest were repaid at the maturity date.

This case was written by Assistant Professors Anton Ovchinnikov and Elena Loutskina as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. The authors thank Assistant Professor Casey Lichtendahl, Jayson Lipsey (MBA '08), and Brian Burke (MBA '08) for their help in preparing this case.

and allow him to continue to be active in a business he dearly loved and completely understood. In March 2007, with $8 million left in company equity, Crawford decided to pursue a new development opportunity.

Development Opportunity

On July 17, 2007, CDC signed a purchase agreement for a 50-acre parcel of land, the Huntley Farm, located on the outskirts of Houston. To gain control of the land, Crawford made a $500,000 nonrefundable earnest money deposit with the Huntley family, which gave him the exclusive right to perform due diligence on the parcel for 90 days. At the end of the 90-day due diligence period, Crawford would have the option to purchase the parcel for the predetermined value of $4.875 million or forfeit the earnest money deposit.

Crawford considered the Huntley Farm a very attractive investment because it provided him a lot of flexibility in terms of choice of construction. First of all, the investment was about the size of deal he was shooting for. Second, it was close to his house in Houston and did not require much travel. But most important, the land allowed him flexibility in choosing the type of development to undertake. A thorough analysis of the Houston real estate market, the location of the Huntley Farm, access to the site, and area demographics suggested that either an office park or a residential neighborhood could be attractive projects to pursue with similar timeframe and cost. The only thing left to do was secure the remainder of the financing for the purchase of the parcel of land and development. Crawford could decide later whether to continue with his plans to do the office development or instead switch to residential.

Southeast Bank of Texas

The Southeast Bank of Texas (SBT) was not a big bank by U.S. standards, but its smaller size and inherent flexibility allowed bank managers to develop closer contacts with customers and to be more selective in the deals they financed. Though the bank had a presence in the residential mortgage business all over Texas, its main market share was in commercial and industrial (C&I) loans and real estate development lending.

Peter Kloeckner, in his 15 years with SBT as a business loan manager, got to know the most and least successful Texas entrepreneurs. He saw the rise and fall of big developers and new entrepreneurial firms. He suffered their losses and celebrated their gains—which were also losses and gains for his department at the bank. He got to know the people who never won, as well as those who never lost. His experience allowed him to distinguish between the two, though his MBA degree from a well-known business school did not hurt either.

Andy Crawford was one of those long-standing clients who never lost. Kloeckner met Crawford the year he started working for SBT and since then, he was continually amazed by the man—and not because all the lending proposals he brought to the bank were approved and made profits for the bank. Kloeckner was in awe of his tremendous presence. When Crawford stepped into the bank's office, everything moved toward this now 66-year-old man. Looking no older than 40, he exuded so much energy wherever he went that everyone around him was immediately affected. Kloeckner could swear that on the days Crawford visited the bank, even bank assistants were more cheerful and all paperwork moved around more quickly.

So in July 2007, when Crawford visited SBT with a new lending proposition, Kloeckner anticipated another smooth ride. Indeed, the proposition and the property brought to the table by CDC seemed very attractive. With $8 million in capital, CDC met the bank's minimum equity requirement of 15% to borrow the amount needed for the total deal of $46.375 million, including additional estimated construction costs. The firm requested a $38.375 million loan for the development, which would be built in two years. The loan had a three-year maturity, providing an extra year to ensure a complete sale of property. A detailed consideration of the deal persuaded Kloeckner even further that the loan should be approved with the bullet structure at a competitive interest rate of 7%.

Trends in the Houston Real Estate Market

In 2007, Houston was the fourth most populous city in the United States,[2] and the second largest city by land area. With the oil and gas industry comprising 50% of Houston's economic activity,[3] beginning in the year 2000, Houston enjoyed tremendous financial prosperity as a result of high oil prices. The Houston market was further fueled by the expectations that oil prices were going to remain at record-breaking levels for the foreseeable future. The impending distress of financial services firms had little impact on the Houston economy, and the overall outlook for economic growth was very positive.

Underpinning the market's robust activity was a strong local economy highlighted by expanding primary industries and healthy job growth. In the 12 months ending in May 2007, Houston added 81,100 jobs, representing a 3.3% growth rate, and recorded a 3.8% unemployment rate down from 5.0% one year earlier.[4] Although the energy industry was central to many of the current economic gains, other key sectors also contributed to the strength of the local economy. The Houston Airport System, Port of Houston, NASA/Johnson Space Center, and the medical sector were all primary drivers that continued to support the local economy. With all five of these primary industries currently expanding, Houston's real estate market was well positioned for continued market gains and growth.

[2] *Market Overview 2007* (Houston-Sugarland-Baytown, TX: Texas A&M Real Estate Center), 2007.

[3] http://www.bayareahouston.com/DATA/Home/DataCenter/RegionalStudies/BayportandtheEconomy/Bayport%20and%20the%20Economy.PDF and http://www.houston.org/blackfenders/10FW002-Data.pdf (accessed December 12, 2007).

[4] http://www.chron.com/CDA/archives/archive.mpl?id=2007_4366977 (accessed December 11, 2007).

Office Market

As the headquarters for hundreds of oil and gas companies, the Houston office market was booming in 2007 as oil and gas companies clamored to expand their offices to meet growing business needs. The Houston office vacancy rate, 10.6% of available office space, was at its lowest level in nearly a decade. The absorption rates also showed magnificent gains, with 2.5 million square feet (s.f.) of positive net absorption in the second quarter, compared with 1.1 million s.f. in the first quarter and 1.7 million s.f. at the same time a year earlier. The reduced market vacancy enabled the buildings' landlords to raise rental rates by nearly 6% in the second quarter alone. On a year-over-year basis, Central Business District class A rents of $32.36 per s.f. posted the sharpest spike in Q2 from $22.69 per s.f. only 12 months earlier; similarly, class B rents increased to $22.33 per s.f. from $18.21 per s.f.[5]

The positive outlook for oil and gas companies coupled with increasing absorption rates and favorable price trends indicated that an office development could potentially be prosperous, with minimized downside. Not surprisingly, such trends led to flooding of the market. New developments totaling 4 million s.f. were under construction at the end of the second quarter compared with less than 1 million s.f. that were under way one year earlier. As a testament to their confidence in Houston's market indicators, many developers were working on multiple projects to be delivered by late 2008 and early 2009.[6]

All these facts taken together suggested to Kloeckner and the bank analysts that, although it was a stable investment with a fairly attractive rate of return, the office development had no dramatic upside potential as a result of the more than 4 million s.f. of new development currently under construction in Houston. These new developments coming on line in Houston would certainly absorb any future growth in the market for the foreseeable future, holding vacancy rates and rental rates constant. The bank analysts' division agreed with Crawford's forecast of a 12% expected return on the investment and suggested approval of the loan. At the time, the commercial real estate market seemed to be more attractive to Kloeckner than the residential development market, which was encountering significant problems across the United States.

Residential Market

In the beginning of 2007, a credit crunch started to unwind in the residential mortgage markets. It started with a dramatic increase in foreclosures for U.S. subprime mortgages. With eight consecutive interest rate increases by the U.S. Federal Reserve, the mortgage market was roiled by a sharp increase in high-risk loans made to borrowers with weak credit. By March 2007, the pain was spreading upward to people designated between subprime and "prime"—typically referred to as "Alt-A" mortgages in the industry. A record $400 billion of these midlevel loans were originated in 2006, up from $85 billion in 2003, according to *Inside Mortgage Finance*. Alt-A loans accounted for roughly 16% of mortgage originations in 2006 and

[5] CBRichard Ellis, *Quarterly Office Market Review, Houston Office,* Second Quarter 2007.
[6] CBRichard Ellis.

subprime loans comprised an additional 24%. Some adjustable-rate mortgage borrowers started to feel the inevitable interest rate increases breathing down their necks. The crisis was also spreading to European markets affecting banks that were heavily invested in U.S. mortgage-backed securities.

The defaults, however, remained very low in the prime market—and despite the uptick in bad loans, the problems in the Alt-A sector were not as severe as those that roiled the subprime market. Nevertheless, these problems dramatically affected the mortgage markets, and by extension, the residential real estate market all across the United States. As a direct result of fledgling financial markets recoiling from subprime credit exposure and an oversupply of new homes, residential housing prices were falling. New-home buyers were having major difficulties obtaining financing for homes, even given the supply of available homes on the market and the recent price reductions home buyers were observing. Many analysts believed that the residential housing market had not yet hit bottom, and further deterioration of the market was expected.

The Houston area was not immune to the troublesome residential real estate market in the first quarter of 2007. In stark contrast to Houston's office market, growth in the residential market had come to a screeching halt during the spring of 2007. Before he saw the second quarter data, Kloeckner thought the choice between the commercial and residential real estate development in the Huntley Farm was a no-brainer. CDC's decision to pursue an office building construction was a reasonable and very attractive proposition.

The picture changed when the August reports on the Houston residential real estate market were released. With widespread news of mortgage companies across the country filing for bankruptcy, shutting down operations, or having difficulty finding money to fund loans, the greater Houston real estate market held up remarkably well in July. Sales actually rebounded from the previous two months' decline. Though the inventory growth of homes for sale slowed from its recent rapid pace, prices were mixed. The only price segment that continued to show signs of moderate weakness was the $80,000 to $150,000 price range, which was clearly a result of the mortgage and lending issues.

Total property sales for July 2007 registered 8,114—a 1.1% increase from July 2006. The value of properties sold during the month reached a total of nearly $1.7 billion, a 5.3% increase compared with sales worth nearly $1.6 billion a year earlier. Additionally, the median home price for a single-family home reached $155,100 for July, whereas the mean was $209,339, a decline of 0.5% and an increase of 1.8%, respectively.[7]

Although the Houston housing market had held up much better than the rest of the country, according to the analysts' report to Kloeckner, the residential development market was still expected to have significantly higher risk than the commercial/office market. Analysis of Crawford's residential project showed that most likely, it would have a hard time breaking even, resulting in sales of about $42.3 million, and further, if the mortgage crisis worsened, one would

[7] http://rismedia.com/wp/2007-08–15/regional-spotlight-houston-housing-market-weathers-mortgageturbulence/ (accessed December 11, 2007).

be lucky to get $20 million. In either case (and in general, whenever cash flow from a project is less than the amount owed in principal and interest), the bank would keep the proceeds from its sales: CDC would receive money only if the sales exceeded the amount owed to the bank for principal and interest. At the same time, if energy prices remained strong, job growth continued in the Houston area, and the local economy showed resilience, both SBT analysts and Crawford agreed that in three years, the residential project could bring nearly twice the sales that could be expected from the office project—$130 million. It seemed that if any market in the country could withstand the impact of the lending woes, Houston might be it.

Dilemma

Kloeckner sat in his office thinking that, with financing in place and the development still in the budgeting stage, CDC might decide to go with a residential development instead of the office project, in pursuit of higher potential profits. His concern was that perhaps this might be more risky to SBT.

He picked up the phone and called Crawford to ask which project he would choose. Crawford replied, "I have to admit that I haven't decided. However, I would like to assure you that our interests here are fully aligned: If I do well, your bank will do well with me. If it's better for me, it's better for you."

Kloeckner wanted to trust Crawford. He knew that some banks had lent money knowing a lot less about clients' development plans. Such knowledge, however, was not particularly comforting to Kloeckner. Hoping to understand how the bank will fare with the two projects, Kloeckner compared them side by side (**Table 1**).

Table 1. Comparison of residential and commercial projects.
(dollars in thousands unless otherwise stated)

	Office	Residential
Crawford's investment	$8,000.00	$8,000.00
SBT loan	$38,375.00	$38,375.00
Interest rate	7.00%	7.00%
Time horizon	3 years	3 years
Interest over three years	$8,636.03	$8,636.03
Total (principal + interest)	$47,011.03	$47,011.03
Expected sales	$65,153.54	$64,100.00
CDC's cumulative free cash flows	$10,142.51	$9,088.97
SBT's cumulative free cash flows	$8,636.03	$8,636.03

Note: See **Exhibits 1** and **2** for the projects' pro forma cash-flow statements.

Source: Created by case writers.

The analysis further supported Kloeckner's feeling that the office project would result in a higher profit, and that therefore, Crawford would not change his mind in favor of the residential development. Kloeckner was not totally convinced, though—intuitively there was so much more risk in the residential project, but his analysis did not show that. Therefore, he called on one of the bank's analysts and asked the analyst to look at the proposed deal further, perhaps based on the history of past deals with CDC. Clearly, the past data was relevant only for the office market; current turbulence in the residential market made much of those historical relationships worthless.

Fortunately, SBT had a long history with Andy Crawford, and thus, such data, adjusted for the borrowed amount and duration of past projects, was readily available (**Exhibit 3**). Kloeckner believed that this data could be used to forecast the revenue from the office project more accurately. In particular, in the past SBT took into consideration a possible dependency of the gap between the stated and realized project sales and the economic outlook indicator. And though the current indicator had not been released yet, Kloeckner and his analysts believed it would follow the historical average; that is, there was a 12-in-32 chance of a pessimistic economic outlook, a 9-in-32 chance of a neutral one, and an 11-in-32 chance of a positive outlook.

Further, while Crawford was fairly certain about the costs of the office project, Kloeckner and Crawford both agreed that the initial construction costs in the residential project could vary somewhat. They estimated that with 95% probability the cost would be within 10% of the expected $20 million.

Not knowing exactly how to use all these data, Kloeckner let analysts wrestle with it, hoping to get some sound results by 3:00 p.m. Meanwhile, he decided to think of proactive measures to protect the bank's interests. Given the cost of funds of 6%, he thought that raising the interest rate offered to CDC was one possibility. Kloeckner realized that although there was basically no way Crawford would refuse a loan at the current rate of 7%, the chances that he would decline a higher-rate loan would increase by 25% for each for each additional percentage point. Thus, quoting a rate above 11% was meaningless—Crawford would never accept it, and quite likely, would be deeply insulted. Kloeckner clearly did not want to insult a good friend and trusted partner.

Exhibit 1

CRAWFORD DEVELOPMENT CO. AND SOUTHEAST BANK OF TEXAS

Pro Forma Cash-Flow Statements for CDC and SBT, Office Project

Interest rate	7.00%				
Sales, in thousands of dollars	65,153.54				
Crawford Development Co.					
	July 2007	Oct 2007	July 2008	July 2009	July 2010
Revenues:					
sales of units					65,153.54
Costs:					
Land	500.00	4,375.00			
Construction		20,000.00	9,000.00	10,200.00	
Sales and marketing				2,300.00	
Interest					8,636.03
Income:	–500.00	–24,375.00	–9,000.00	–12,500.00	56,517.51
Loan inflow	38,375.00				
Loan outflow					38,375.00
Free cash flows (FCF)	37,875.00	–24,375.00	–9,000.00	–12,500.00	18,142.51
Cumulative FCF	10,142.51				
Southeast Bank of Texas					
Repayment of principal					38,375.00
Interest					8,636.03
Lending	38,375.00				
Free cash flows (FCF)	–38,375.00	0	0	0	47,011.03
Cumulative FCF	8,636.03				

Source: Created by case writers.

Exhibit 2

CRAWFORD DEVELOPMENT CO. AND SOUTHEAST BANK OF TEXAS

Pro Forma Cash-Flow Statements for CDC and SBT, Residential Project

Interest rate	7.00%				
Sales, in thousands of dollars	64,100.00				
Crawford Development Co.					
	July 2007	Oct 2007	July 2008	July 2009	July 2010
Revenues:					
sales of units					64,100.00
Costs:					
Land	500.00	4,375.00			
Construction		20,000.00	9,000.00	10,200.00	
Sales and marketing				2,300.00	
Interest					8,636.03
Income:	–500.00	–24,375.00	–9,000.00	–12,500.00	55,463.97
Loan inflow	38,375.00				
Loan outflow					38,375.00
Free cash flows (FCF)	37,875.00	–24,375.00	–9,000.00	–12,500.00	17,088.97
Cumulative FCF	9,088.97				
Southeast Bank of Texas					
Repayment of principal					38,375.00
Interest					8,636.03
Lending	38,375.00				
Free cash flows (FCF)	–38,375.00	0	0	0	47,011.03
Cumulative FCF	8,636.03				

Source: Created by case writers.

Exhibit 3

CRAWFORD DEVELOPMENT CO. AND SOUTHEAST BANK OF TEXAS

Historical Data about the Three-Year Business Development Loans SBT
Provided for CDC for the Development of Office Buildings
(in thousands of dollars)

Loan ID	Stated expected sales	Leading indicator of economic outlook*	Realized (actual) sales
1	66,382.35	–1	51,302.37
2	60,852.39	0	63,452.49
3	65,872.30	0	67,932.41
4	64,541.97	1	79,689.09
5	73,871.30	1	70,408.31
6	52,689.86	–1	46,006.15
7	63,470.57	–1	61,575.80
8	55,828.80	1	65,413.68
9	63,972.39	0	57,756.02
10	61,999.35	1	72,319.87
11	78,151.43	1	84,962.93
12	75,928.84	1	82,105.66
13	73,195.79	–1	64,361.14
14	70,009.95	–1	64,554.01
15	58,471.00	0	56,729.86
16	66,242.29	1	76,268.45
17	79,315.70	0	84,896.93
18	60,000.95	–1	43,384.19
19	60,839.91	1	68,533.78
20	65,844.29	–1	51,601.49
21	70,511.40	–1	62,379.33
22	49,527.53	–1	36,775.17
23	67,793.12	0	70,128.14
24	72,333.48	–1	61,806.21
25	55,992.65	1	68,218.22
26	75,956.10	–1	63,401.88
27	61,969.04	0	60,720.96
28	55,875.70	0	65,842.55
29	74,283.09	1	78,509.94
30	85,382.88	0	83,909.33
31	69,717.37	1	87,853.35
32	56,725.72	–1	38,732.77
Mean	66,048.42		65,360.39
SD	8,435.27		13,301.35

*1, 0, and –1 in the economic outlook correspond to the optimistic, neutral, and pessimistic forecasts, respectively, of the economic climate for the time horizon of each loan. These were leading indicators known at the time the loans were granted or shortly thereafter.

Source: Created by case writers.