

Buffett Becomes Vulture as HomeServices Seeks Deals (Update2)

By Kathleen M. Howley



Sept. 2 (Bloomberg) -- [Ron Peltier](#) runs [HomeServices of America Inc.](#), the second-largest U.S. real estate brokerage, and unlike No. 1 NRT Inc., his company is making money in the worst housing [slump](#) since the Great Depression.

HomeServices also has a parent, [Warren Buffett's](#) Berkshire Hathaway Inc., with \$28 billion of cash to help finance the purchase of brokerages that can't weather the housing recession. By contrast, NRT's parent Realogy Corp., owned by [Leon Black's](#) Apollo Management LP, has at least \$875 million of debt that has an 89 percent chance of defaulting within five years, credit-default swaps tracked by London-based CMA DataVision indicate.

Three years of tumbling U.S. home sales and [prices](#) may give Peltier, who says he fields as many as three calls a week to his Minneapolis office from desperate brokerages seeking a buyer, a chance to grab market share. NRT's pace of acquisitions has dropped to four this year from an annual average of 20 since 2002 as Realogy's debt ratio -- borrowing relative to earnings before interest, taxes, depreciation and amortization -- increased to 4.9 in June from 3.8 at the end of 2007.

``Cash is king," Peltier said in an interview. ``If you've got cash available, you have the opportunity to take advantage of some great buying opportunities."

NRT's options are limited by the growing debt of its parent, said [Steven Kaplan](#), a finance professor at the University of Chicago Graduate School of Business. Realogy, based in Parsippany, New Jersey, said it will pay interest in October on \$550 million of 11 percent notes due in 2014 by borrowing \$32 million. The company had total debt of \$6.4 billion at the end of June.

Capital Structure

“If you are paying debt with new debt, you're not in a position to be making acquisitions,” Kaplan said. “Unless a move puts extra cash on their balance sheet right away, it's not happening.”

[Richard Smith](#), chief executive officer of Realogy, said in an Aug. 25 interview that NRT is buying fewer brokerages because “sellers have not been quick to drop their prices to keep pace” with the industry's decline in revenue.

“The capital structure to handle all of our needs is in place,” Smith said. “We are still acquisitive, if the deal makes sense for us.”

Peltier said he expects to spend \$200 million in the next two years paying 20 cents to 25 cents on the dollar for distressed brokerages to get HomeServices into new markets. The HomeServices chief executive officer said he couldn't give details on pending deals, though he expects at least one to close by the end of the year. HomeServices spent about \$10 million buying companies in the past year, Peltier said.

‘Tuck-in’ Purchases

“Since mid-2006, we've been focusing on tuck-in acquisitions: smaller companies that can be folded into an existing primary market,” the 59-year-old Peltier said. “We think we are starting to see signs of the end of the downturn, so our interest is growing in making some very noteworthy acquisitions going forward.”

HomeServices is part of Berkshire Hathaway's Des Moines, Iowa- based [MidAmerican Energy Holdings Co.](#) When the housing slump started in 2006, Buffett, who declined to be interviewed for this story, said the market's woes “should lead to additional acquisition possibilities.” He said in his annual shareholders letter that year that HomeServices would probably be “far larger a decade from now.”

NRT had 939 brokerage offices at the end of 2007, compared with HomeService's 379, and more than triple the sales, according to real estate research and publishing firm Real Trends in Denver. NRT sold \$174 billion of homes in 2007, compared with HomeServices's \$50 billion. NRT is in 35 of the largest U.S. real estate markets, while HomeServices is in 24.

Buffett's Approach

“Last year was a slow year for residential sales, and 2008 probably will be slower,” Buffett said in his [annual letter](#) to investors published six months ago.

“We will continue, however, to acquire quality brokerage operations when they are available at sensible prices.”

That opportunistic view of the worst [housing recession](#) in seven decades is “classic Buffett,” said [Charles Hamilton](#), an analyst at FTN Midwest Securities Corp. in Nashville, Tennessee.

“When you have Buffett’s long-term investment philosophy, you can wait for things to go on sale,” Hamilton said. “In the real estate brokerage business, this is the perfect time to be a buyer and a terrible time to be a seller.”

Peltier’s purchases follow the Buffett pattern. He looks for strong management, keeps the local brand name and the top executives, and lets them run the company with little interference, just as Buffett tends to leave him alone.

Local Brands

The real estate business “is highly cyclical, yet one we view quite enthusiastically,” Buffett wrote in his February 2004 letter to investors. “We have an exceptional manager, [Ron Peltier](#), who through both his acquisition and operational skills is building a brokerage powerhouse.”

When NRT buys a business, it relaunches it under one of Realogy’s [franchises](#), such as Coldwell Banker or ERA, said Smith, 55, in last week’s interview.

“We substantially improve the bottom line by collapsing new companies under one brand,” Smith said. “We believe consumers are more and more leaning toward national brands.”

HomeServices’s pretax profit fell 71 percent to \$42 million last year from the peak of \$145 million in 2005, according to President [Robert Moline](#). In the first seven months of this year, pretax profit was \$2 million, helped by \$90 million of cost-cutting since 2007, Moline said.

Peltier said he’s got enough money to weather the housing decline. If an opportunity is too big to handle in-house, Peltier can tap Berkshire’s cash.

Omaha, Nebraska-based Berkshire Hathaway has the highest [AAA rating](#) from Moody’s Investors Service.

Credit Rating Cut

Moody’s downgraded [Realogy’s debt](#) this month by one grade to Caa1 from B3, citing the dangers of the real estate recession and its “highly leveraged capital structure.” Moody’s assessed the rating outlook as “stable.” Caa1 is the seventh-lowest speculative, or junk, grade.

Realogy had a net loss of \$27 million in the second quarter, with the brokerages at the NRT unit reporting an 8 percent year-over-year decline in average sale price as they handled a growing number of foreclosures. NRT paid \$75 million in intercompany royalties and marketing fees to Realogy Franchise Group during the period for using the brand names it licenses. On a pretax basis, Realogy lost \$46 million in the second quarter.

'Walkovers'

NRT's expansion plans are focused on "walkovers," recruiting top producers from other brokerages, Smith said on an Aug. 14 conference call with investors and analysts.

"The vast majority of brokerages contemplating a sale are probably going to wait until the [market](#) improves a little bit so they have some earnings," Smith said in last week's interview.

NRT has access to Realogy's \$750 million revolving line of credit put in place when Apollo acquired the company for \$6.8 billion in April 2007, Smith said. Apollo financed the purchase with \$2 billion of equity and \$4.4 billion of debt, in the form of bank loans and bonds. Realogy, not NRT, is carrying the debt, Smith said.

During the Aug. 14 conference call, Smith told investors that Realogy had a balance of \$205 million on the revolving line of credit as of June 30. The company expects to keep its debt ratio below the maximum cited in the credit agreement, which currently is 5.6, Smith said on the call.

If the housing slump continues into next year, Realogy may have difficulty meeting the loan terms, said [Lenny Aizenman](#), a Moody's Investors Service analyst. The ratio will tighten to 5 by next September, according to an Aug. 8 report from Moody's.

Apollo's Black "is a smart guy," said [Paul Schaye](#), managing director of New York-based Chestnut Hill Partners LLC, which helps private-equity funds identify investments. "If the underpinnings of a deal make sense, he will financially engineer it. But if a deal doesn't support the bottom line, it's not going to happen."

Edina Roots

Measuring so-called transaction sides, a standard industry gauge that counts the involvement of a selling and a buying agent for every deal, NRT was ahead of all its peers. The company had 326,323 sides in 2007, down 17 percent from the prior year, according to Real Trends.

That was more than twice as many as HomeServices's 152,826 sides in 2007, which fell 16 percent from a year earlier, Real Trends said.

While NRT's acquisition pace has slowed this year, one purchase hit close to HomeServices's turf: NRT's Coldwell Banker Burnet in Edina, Minnesota, bought the four offices of RHS Realty in surrounding towns of the western Minneapolis suburb.

Edina, where Peltier got his 1977 start in real estate after a two-year stint as a history teacher and hockey coach, is also the town where he first started moving up the management ranks at Edina Realty, now owned by HomeServices. Peltier said his company wasn't interested in buying RHS Realty.

“It wasn't a beneficial acquisition for us to go after because we already dominate that market,” Peltier said.