

Ground Control: Cash and Carry

The plight of home builders who need to shed land sets up a moment for financial players to pounce.

By Lisa Marquis Jackson and Lisa Brown

After months upon months of big talk, pure financial players' hungry foray into home building suddenly seems about to move past the flirtation stage—way past it. Private equity firms, global investment banks, insurance companies, and even high net worth individuals have been creating a financial district stir as they clamor about in fundraising posses. They're angling to assemble capital war chests, which they plan to plunge into a residential real estate market whose strategic powers—the leading home building companies—are mostly stuck in neutral, struggling mightily to keep their balance sheets cash flow positive.

Today, big builders are moving in droves with swift abandon to lighten their asset and inventory holdings to a necessary minimum load for just-in-time home delivery. What home builders don't want gives others a window of opportunity—now financial players can do more than merely finance builders.

Land, marked to market for transactions at a shadow of what it was worth 18 months ago, has just gotten a whole lot more attractive as an investment.

"Most people think we are there," says JMP Securities managing director Phil Whitcomb of the pair dancing that has been taking place between investors and operators. "[Many] have the attitude that we are at the bottom; we don't know when it will turn up, but we need to be out there talking to people. Depending on how aggressive they are, they'll start locking up a partner who knows the business and start looking at deals."

Now that Lennar's joint venture arrangement with Morgan Stanley has tangibly—albeit, arguably—set a standard of land prices on a broader level, the implications are that investors who've been waiting on the sidelines will enter the residential real estate arena with a vengeance while the getting is good.

"It gives them the confidence to go in," says Norm Scheel, president of The Hoffman Co. "There is also a little bit of a fear that, if they wait too long, the window will close. I think it will encourage people to be nimble and be quick or they are going to miss opportunity."

Exactly one week after Lennar sold 11,000 lots in eight states to Morgan Stanley, and separately off-loaded 8,300 Florida-based lots to Metro Development, Crosland Communities announced the formation of the Southeastern Investment Fund in a partnership with Northwestern Mutual. With an equity commitment of \$225 million, the fund will deploy in conjunction with Charlotte, N.C.-based Crosland's corporate capital investments and is focused on acquisition of land for large-scale, longer-range developments.

"One of Crosland's competitive advantages has been our private funding," says Todd Mansfield, Crosland's chairman and CEO. "Historically, this allowed us to invest in communities with an emphasis on long-term value creation over short-term returns. The Southeastern Investment Fund allows us to strengthen this advantage, while also broadening our reach and expanding our development pipeline."

JMP's Whitcomb conjectures that the Crosland deal is significant in that it represents the entry of large insurance companies—typically a more conservative investor group—into residential land. Which begs the question: Who else is out there trying to place money into the residential game?

Amid the smoke and mirrors that in most cases yield only the fuzziest picture of how capital assembles into investment strategies, it can be difficult to detect which investors will commit to what.

One of the more conspicuous groups is what's referred to as the "bulge bracket" of investment banks. All appear to be pitching land funds—including Bank of America, Merrill Lynch, JPMorgan Chase, Goldman Sachs, Citigroup, and Morgan Stanley, to name a few.

As vast and potent as they are, they have company in the game. The insurance sector represents a typically more cautious class of institutional investor now evidently exploring the opportunity. Although Northwestern Mutual may be the first to commit, others are said to be kicking tires. "They will probably play in this a little bit, but they aren't leaping in quite yet," says Whitcomb.

PRIVATE PARTIES

Clearly generating a whole lot of buzz is private capital in the form of private equity funds. For instance, Forestar Land Partners formed last summer through a partnership between Starwood Capital and Foremost Communities, based in California. Run by former home building executive Steve Cameron, the joint venture is infused with \$250 million to deploy on land in the region.

In a category by themselves are individual investors willing to put their skin in the game. "They act and move just like the Wall Street money," says Hoffman's Scheel. "But the nice thing about them is that they aren't pledged money; they actually have the money. And it is sitting there waiting to buy opportunity."

Case in point: the Mirage family. Formerly in the food industry, the company sold out to Nestle for \$1.6 billion, according to Scheel. "Their flagship product was Hot Pockets, but today they want to

go out and invest in land," he says. "And they have the money to do it."

The dollar magnitude of assets under management among the various players runs a wide gamut, but executives familiar with several of the emerging groups estimate that the average size fund for land deals in today's environment is \$250 million.

Although most investors recognize current land valuations as approaching their lowest price point, what remains unclear is how long they'll remain there. So, how patient is the money sitting on the sidelines?

Scheel says most of the investment assumptions at work call for a three- to five-year horizon, a timeline expected to correspond with the moment builders will once again experience a need to expand their lot pipelines. However, Whitcomb suggests taking a more conservative view when structuring partnerships in light of continuing uncertainties ahead.

"The parameters are different for different funds," says Whitcomb. "Some are specified as distressed assets, and some are not. Those that are [distressed] tend to be a little more aggressive. People who really understand this business understand that they are going to get their money back, but it may not be in three to five years. It may be five to seven."

"We believe that if we make an offer on a property and [the owner doesn't accept it], they'll be back," says Ralph Grebow, CEO of The Atlantic Cos. and a speaker at the Big Builder '07 "Breakthrough" conference in November. "Maybe it's a vulture fund, but it's the hard, cold fact of today. Nobody's going to hold this [land]; everybody's going to move it. ... Cash is king, even if it's just a little."
—Lisa Marquis Jackson

CHURCH AND STATE

Land minds predict a line in the sand will emerge between land development and home building business models.

During the Big Builder '07 "Breakthrough" conference in Las Vegas, senior editor Les Shaver kicked

off a session titled "The New 'A' Locations" with a joke about overhearing an architect refer to "land" as a four-letter word." However, the subjects tackled during this timely session were anything but a laughing matter.

"How did we wind up where we are, and where do we think we'll end up in the future?" Jeffrey M. Gault, CEO of LandCap Partners, asked the room full of builder attendees. The consensus among the panelists—including Mike Straneva, director of transaction real estate for Ernst & Young; Ralph Grebow, CEO of The Atlantic Cos.; and Peter Tremulis, principal of Sunesta Resort Communities, in addition to Gault—was that production home builders will need to move away from a business model that relies on heavy land margins.

"You have to decide whether you're a builder or you're a developer, and if you're a builder, are you going to do the same things that you've done



Photo: Jaime Windon

LIQUID CONCERNS: Mike Straneva, director of transaction real estate for Ernst & Young, said that what happens on the banking front in the coming months will determine if the pressure will be on for smaller, regional builders with respect to liquidity.

before, or are you going to try to change your model?" said Grebow. His theory? In the end, the model will change, regardless: "You are going to be in the finished-lot business if you are a builder."

Citing the inefficiencies of the real estate market, Grebow predicted, "If you decided you wanted to build 100 houses, you're going to build them by buying them from a developer. Whether you're a public or a private, you're going to pay for the ability to do that. The developers are going to be a

lot more concerned about whether or not you're going to walk. ... I think, many times, the developer's going to ask for a piece of the sales price; generally, I think it's going to be a different world."

Tremulis attributed the new-home building market's current dire straights to the behavior of builders: "They didn't sell their homes—they built their plan."

According to Gault, 60 percent to 70 percent of home sales price reduction falls straight to residual land value. He posited two choices for the builders in the room: either take impairments, defer tax losses, complete the project, and sell to the public at today's prices with no profit or potential losses (what he referred to semi-facetiously as "building for practice"), or else sell to a third party at current market prices and take advantage of new liquidity to partner with a new ownership structure and generate profits.

NIMBLENESS RULES

As liquidity becomes a progressively more important issue in the coming months, especially for smaller, regional builders, the pressure will be on. "The 'A' locations are going to require a lot of stability from a structural standpoint," Gault said, adding that large land holdings may not fit into that picture right now.

Grebow also pointed to the necessity of builders reevaluating their relationships with banks. "It is a cyclical business; it will not change," he explained. "As soon as the market turns a little, the banks distance themselves from the builders. Builders are going to have to come to grips also, in terms of pricing, with the understanding that the days of going to the bank and putting equity from one job into the next are over."

Furthermore, Grebow asserted that builders must partner with institutional capital out of necessity. "In the final analysis, you're going to



Photo: Jaime Windon

"They didn't sell their homes—they built their plan. ... Production has run amok."
— Peter Tremulis, Sunesta Resort Communities.

overpay for money, but you're going to try and partner with someone who will stick with you longer than until the next downturn," he said. "You're going to be in it with some larger players to get more equity to lever down on the banks, so your loan-to-value is low enough that it's not the end of the world all the time. You make less money, there's consolidation, fewer builders, but they are in it for the long term."

The caveat, said Gault: "All bets are off if we go into recession."
-Lisa Brown

SOMETIMES A FANTASY

What would an "A" location that works in 2008 look like?

Jeff Gault models his ideal:

- Strong economic trends (jobs and growth)
- Good location (access and lifestyle)
- Mature and healthy community structure (existing schools and services)
- Home price that matches homebuyer income (conventional mortgages and underwriting)
- Pricing comparable to existing resales with no premium for new construction
- No post-closing long-term infrastructure costs
- No affordability issues
- No community bond payments by the homeowner
- No project dependence on speculative price increases in the future

THE DIRT

So Long Sacramento

In November, Meritage became the latest big builder to consolidate operations in the Sacramento area. Though the company plans to continue sales and construction at its eight area new-home projects, it has closed its office and laid off its accounting and human resources staff. Others that have consolidated operations in the region include Standard Pacific and Warmington Homes.

KANSAS CITY RETREAT

Despite its market share rank as the third largest builder in terms of permitting, Pulte Homes began a staged exit from the Kansas City metro area in mid-December. The company sold more than 300 homes in the market last year, but decided to focus capital resources in other areas with more consistent returns.

ABOUT FACE

After entering the Southeast Michigan market in 2006, Ryan Homes—a subsidiary of NVR—will exit the state after completing 10 already-permitted homes in its two active communities. In total, the company built 61 homes in the market during 2007.

GOT SOME DIRT?

Please send any information regarding land transactions or upcoming developments in your marketplace to Lisa Marquis Jackson at ljackson@hanleywood.com.