

# Preying on Land-Developer identifies what the three leading buyers of land today demand.

By Lisa Marquis Jackson

For more than 18 months, the industry has been abuzz with talk about the billions of dollars in capital roosting in real estate. Private equity firms, global investment banks, insurance companies, foreign investors, even high net-worth individuals have all been posturing, waiting for that sweet moment when their return threshold and risk calculations will pencil out.

During the residential real estate boom (from 2004 to 2006), capital was a commodity. Debt and equity financing were not only available—they were also inexpensive. But material changes occurred when capital market spigots shut off entirely earlier this year.

Today, banks are faced with a flow of defaulted or impaired development loans. And a shift in risk tolerance is manifesting itself through more secured lines of credit, or a substantial increase in borrowing costs.

In effect, it's a self-perpetuating cycle: Bad loans lead to less lending, which causes even more strain because the pro forma projections that original loans were modeled upon also disappear. Translation: There is more pain ahead.

As the banking industry continues to lose faith, it is doing whatever it takes to get out of real estate—including pushing landowners into insolvency or shutting builders down completely. And the residential building and development community is in utter turmoil as money is being pulled from the space.

"The industry may never be the same, and everyone connected to this industry will have to rethink their strategic plan," says Larry Dunn, director of Eustis, Fla.-based builder and developer Pringle Holdings.

As overleveraged home builders and developers become increasingly desperate for cash, land assets at distressed prices are a veritable candy store for today's hungry investors. Given all of the smoke and mirrors surrounding the capital markets, it's difficult to see the chemistry, style, and expectations of today's willing investors. Here, Developer lends a hand, defining the three archetypal land buyers playing the field today.

## THE PRIVATE EQUITY INVESTOR: A BOTTOMLESS PIT?

While the most visible group of buyers is still the "bulge bracket" of investment banks, private equity firms are now emerging as one of today's most logical solution providers.

Still, the venerable names in banking—Bank of America, Merrill Lynch, JPMorgan Chase, Goldman Sachs, Citigroup, and Morgan Stanley, to name a few—are still considered to be the largest (and until recently, the most profitable) investment category in the world. But in just the last few months, these banks have become more conservative as they assess risk and restructure their exposure in the industry. And that leaves the playing field open for private equity firms that want to deploy funds into residential real estate.

Indeed, private equity firms are plentiful, actively exploring how to niche themselves and how best to align with local expertise for underwriting and implementing investments. And like banks, private equity firms seek returns of about 25 percent, but they have different tactics.

Take Dallas-based RSF Partners. Earlier this year, the private equity fund manager led a joint venture formed to acquire bulk



Open Season: The proliferation of distressed land assets in today's market is being scrutinized by a variety of traditional and nontraditional investors.

assets from Dallas-based Centex Homes. The \$161 million transaction included roughly 8,500 lots in 27 neighborhoods across 11 states, with the majority in California and Nevada. The deal reduced the builder's total supply of lots by nearly 10 percent and made RSF Partners a player in the residential development business.

"We are a different kind of money," says RSF Partners managing director Chris Mahowald of private equity in general. "We are the anti-public capital. We have the ability to be more patient and creative and, in this environment, to not use leverage. The challenge is how to underwrite it.

"[Today's market] is our kind of market," he continues. "You could make the argument that if the housing market continues to deteriorate—and we can't buy or lend our way out of the continued downturn—there are a whole lot of projects out there counting on home builders as take-outs. And the cavalry is not coming."

Mahowald goes on to note that the key factor for private equity players is in the underwriting. "You have to be really careful and use conservative absorption and pricing assumptions," he says. "It's everything we weren't doing two years ago when equity capital was inexpensive and there was so much economic freedom."

To date, the much-ballyhooed influx of this private equity money has been virtually nonexistent because of the persisting gap between the asking price and the bid price. But as deals increasingly come under pressure and land is forcibly marked to market at a shadow of its former worth, market dynamics may be starting to shift.

"The pressure continues to build on these land owners and builders, and we are starting to see more of the 'A' locations that people weren't willing to part with before," says Mark Oei, managing director of a \$1 billion real estate fund at OakTree Capital Management, a private equity firm based in Los Angeles. "But people are still in a little bit of denial."

#### **THE WEALTHY: OFFERING COLD, HARD CASH**

Meanwhile, a second group of land lovers is stepping forward to express interest in deploying their money in today's development arena—high net-worth individuals.

According to brokers and investment bankers familiar with deals that have been executed, this investor group acts and moves just like Wall Street money. But the benefit of this type of capital is that it is not "pledged" money, as is often the case

with funds. With these wealthy citizens, it's real, available money.

"They are boots-on-the-ground people," says Norm Scheel, president of Irvine, Calif.-based Hoffman Co., a land brokerage and realty advisory firm. "They are regional or more local people that have experience with land for generations. It's not a part-time job. They are real market timers."

Case in point: the Mirage family. Formerly in the food industry, the family sold its company—including the flagship Hot Pockets brand—to Nestlé for \$1.6 billion, according to Scheel. "Today, they want to go out and invest in land. And they have the money to do it."

Justin Esayian, a land broker with Hoffman, says these types of investors typically have existing assets in multifamily, industrial, and commercial real estate. And most are looking at how the land cycle will contribute to the sectors they are already in.

As a result, location seems to be a key consideration for these investors. While Wall Street is scouting any and all deals for an opportunity to reel in a 25 percent to 30 percent invested rate of return (IRR), high net-worth individuals are motivated to find properties that ensure a foothold in their key markets and help round out their investment portfolios. Given an opportunity to secure a critical piece of land for their portfolio, these investors are much more likely to accept an IRR in the mid- to high-teens, Esayian says.

"Some have money in generation-skipping trusts, so the nature of the money is on a different time horizon," Esayian says. "They tend to be looking more at the quality of the assets [versus] IRR. IRR is obviously still important, though."

In the current economy, though, this money is proving to be more patient. A number of these transactions—most of which take place under the radar to protect the buyer—reportedly take place at the end of the calendar year. That's when sellers are motivated to capture tax carrybacks and buyers can typically negotiate better deals.

What's more, these individual investors have a competitive edge in their ability to be nimble. With cash in hand—and no investment committee to consult before making deals—they can wait for over-anxious fund money to deploy. "They want to be the third or fourth [offer] on the escrow after it has blown out of two or three other funds," Esayian says. "Many investors are driven by a three- to five-year window, but theirs have greater flexibility and tend to be more in five- to seven-year windows."