

# What a Difference a Year Makes

As the real estate market continues to recover, homebuilders will increase their lot inventories to meet demand, thus creating a window of opportunity for favorable returns to investors.

By Greg Vogel

It was the end of the first quarter of 2009 when a significant shift occurred in the residential finished lot market. Public homebuilders began an acquisition phase with Meritage Homes and Richmond American Homes leading the charge. To truly understand this dynamic shift, it's critical to revisit this recent real estate cycle.

In 2007, local investors and private equity dominated the lot purchases as builders unloaded less desirable lots to harvest cash and capture net operating losses. Builders spent this time unloading standing inventory in an attempt to fill their cash reserves with proceeds from sales and additional net operating loss tax refunds.

As the market remained challenging through 2008, the most commonly asked question by finished lot investors was, "Am I catching a falling knife?" as they voiced concern of their high-risk investments that were continuing to lose value. Some caught the knife; however, most did not.

While signs of market recovery began to appear during the first quarter of 2009, top public homebuilders armed with approximately \$12 billion in cash began waving their "buy flag," ensuing a fast pace of acquisitions of finished lots in highly desirable locations. Investors of finished lots and/or land have yet to question their investments in the same concerned manner as they once did, which demonstrates a clear sense of evolving confidence in the market.

This sense of confidence has led spectators to question the current urgent investment decisions of homebuilders today. The most common questions are, "Are the public homebuilders getting too far ahead of the

market recovery by loading up on finished lots and paying more money than a pro-forma can justify?" "Is private equity getting so anxious to 'use it before they lose it' that they are also getting ahead of the natural progression of recovery?" Housing activity over the next two to three years will answer these questions and illustrate each strategy's successes and losses.

Homebuilders have uncovered a potential gold mine in the high growth areas of the country that possess favorable demographics and strong job centers. Even the hardest hit markets, including Las Vegas and Phoenix, are proving to be of great interest to public homebuilders as they begin to aggressively pursue raw land for 2012-13 deliveries.

For homebuilders, the unfortunate sentiment of the "last man standing" is finally coming to an end. Most of the surviving homebuilders have

now reduced expectations of margins and are building to cover overhead and generate top line revenue growth. Builders that are lucky enough to endure this real estate cycle must go forward with an attitude of appreciation.

Relative to the increasing amount of bank-owned property now being offered in the market, private equity has shifted its focus from finished lot acquisitions in the pursuit of FDIC large debt pools and the opportune investment in start-up and resurgence entities for new building programs. Private equity had difficulty sourcing their minimum investment requirement of \$10 million in finished lots, and, now with a lack of financing for A&D, private equity will fill the gap for larger platform plays and A&D investments.

As for the opportunistic investor, the finished

lot game appears to be over. A shift is soon to occur in lieu of vulture buying, as a result of the new alchemy of the rolling option and how we keep builders land light. As future land investment strategies will differ, one commonality will remain consistent: builders will need to reload for the projected growth ahead and establish longer relationships with patient owners who will deliver timely lots.

Looking back on the past year, one thing is certain: the real estate industry continually plays on the margins of the extreme. At its peak or at its deepest depths, change is inevitable and those who are able to adapt will lead the market.



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## Fast Facts

- In Q1 of 2009, public homebuilders loaded up on finished lots in desirable areas.
- Most surviving homebuilders reduced expectations of margins and are building to cover overhead and generate top line revenue growth.
- Builders will need to reload for projected growth.