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Growing hunger for raw land

Unimproved property can be cheap, but financing poses challenges

BY STEVE BERGSMAN, FRIDAY, MARCH 19, 2010.

As 2009 limped to a close, down in suburban Miami beleaguered homebuilder Lennar Corp. sold a 9-acre parcel of raw land for $2.3 million. The property, located in the city of Kendall, was, according to press reports, originally acquired in 2003 for $15 million, but I assume Lennar executives were just happy to get the property off the company's corporate books, where it sat as a non-revenue-producing asset.

The deal was notable because the market for raw land has been relatively quiet over the past three years, despite best efforts to make something happen.

Beginning around 2007, a number of investment groups began raising capital for raw land, which had been aggressively accumulated by real estate investment trusts (REITs) and individual investors during the boom years but became toxic to corporate accounting during the bust.

One of the early strivers for raw land was Foremost Communities LLC in Irvine, Calif., which in 2007 formed a joint venture with Starwood Capital Group Global LLC of Greenwich, Conn., to acquire undeveloped property.

I caught up with Steve Cameron, Foremost's CEO, at the start of the new year and he admitted the joint venture hadn't bought any raw land because it was instead acquiring finished lots at below replacement cost.

That's been the problem for raw land -- improved land deals just seem more attractive. "I can buy a finished lot for $20,000 where the cost of improvements were $100,000," explains Cameron. "In essence, I'm buying the improvements at 20 cents on the dollar, paying nothing for the land."

In a recession, there seems to be a step-ladder approach to land. First to sell are finished lots, then partially improved land, and finally, raw land (no improvements and no entitlements).

Two years ago, H. Ross Ford, CEO and president of TCN Worldwide in Plano, Texas, argued in print that the credit squeeze following the subprime blow-up created opportunities for raw land acquisitions.

His thesis held that in certain hot markets like Nevada or Florida, homebuilders had amassed large amounts of raw land for development, but with the value of that land heading deep into a trough they needed to dispose of all that acreage.

I asked Ford if his argument was still valid two years later. "The dynamics haven't changed," he replied. "A tremendous amount of raw land has become devalued in the course of the economic cycle. As such there are opportunities to buy at the bottom of the market."

Most of these opportunities have been unrealized, generally for two reasons.

1. If you don't have the cash, it's tough to find financing for raw land deals. Ironically -- but logically -- in places like Florida, Las Vegas or Southern California where there are tremendous bargains in raw land, the likelihood of getting financing are the slimmest.

2. For investors, a second roadblock has been a reluctance by financial institutions to just dump assets, including raw land, into a commercial real estate market that is already flooded with product.

The banks are in a curious position here. First, the established financial institutions were never major lenders for raw land, so they don't have a lot of it to dump. On the other hand, what they do have was eased back into the market during 2009, with more to come in 2010.

Since the banks weren't doing much in the way of raw land deals during the boom, their place at the financial roulette wheel was taken by hard-money lenders, which, as a group, have experienced high rates of mortgage failure and will need to flush a lot of foreclosed land back through the system.

Presently, most of the deal flow is coming from existing financial institutions and also failed banks through the Federal Deposit Insurance Corp., observes Jason Perrin, founder and principal in Greencrossing Real Estate Cos. in Aliso Viejo, Calif. "Deal flow picked up in the latter part of 2009 and we are going to see more raw stuff come through the pipeline in 2010." .

There are a couple of key points to consider when investing in raw land.

First of all, prices are -- pardon the pun -- all over the place, because in many badly hit regions, raw land in a technical sense has no value other than speculation.

For example, in 2005, a home in a partially completed development sold for $500,000 with $100,000 of that covering the cost of the land. Now that house is worth $350,000, with the $150,000 decline attributed to the land, giving it a value of minus $50,000.

No one is going to give the rest of the land in the development away, so a buyer might offer $5,000 for the land and the seller responds by saying, "I will (or will not) sell at that price." Let the negotiations begin.

Secondly, investing in raw land often means a lengthy hold period. Raw land Rule No. 1 says: the further the distance from the center of business and residential activity, the longer the hold.

On the other hand, Rule No. 2 maintains: the further out, the less maintenance. Closer in, community regulations can demand a certain level of standards for the property. Taxes will have to be paid during the hold period, but in some locales if the land is used for grazing or agriculture, tax breaks can be achieved.

Stronger markets recover first so many investors will only buy in A and B locations.

Jurisdictions are also important because some cities make it easy to get entitlements and other cities do not. Although, as Perrin points out, now is a great time to process entitlements.

"These are tough times, and counties and cities are happy to get from developers any sort of extraction," he says. "Developers have more leverage right now to emerge ... with entitlements and at less cost."

One theory about raw land holds that bigger is better because the cost entitling 2,000 acres is probably not much different than entitling 200 acres. Nevertheless, smaller investors shouldn't despair.

Ford gives this example: A friend bought 18 acres of raw land outside of Dallas 10 years ago. He paid $14,000 an acre. He was recently offered $50,000 an acre for it and turned it down.

"Nothing precludes you from buying 10 acres well beyond the current growth parameters of your city and holding onto it until the time comes to sell sometime in the future," Ford said.