LOTS, LAND, AND OPPORTUNITY

POST-RECESSION, BUILDERS ARE FINDING THAT THERE'S MORE THAN ONE WAY TO THE LAND AND LOT PIPELINE

By Mike Beirne, Senior Editor

How a land deal comes down can depend on which direction the crow flies.

Drive a couple of hours west from College Station, Texas, to Killeen, and Doug French, CEO of Stylecraft Builders, can secure lots through a land option deal with a developer that also sells parcels to D.R. Horton and other big builders. That supplier is comfortable with takedown contracts. But drive a little more than an hour east to Conroe, and French is dealing with developers who were burned during the housing crash.

"They will not put a land sale on an option because they don't want to get burned again," French says. "They want you to buy the land from them, and you put in the infrastructure yourself."

Stylecraft found a niche of entry-level buyers by targeting Millennials who didn't stray far from Texas A&M, Baylor, Sam Houston State, and other college towns after graduating. They've gotten their first or second jobs and saved enough money to buy their first home. But in some locations, the lot supply is skimpy, so Stylecraft buys the dirt and takes on the entitlement and infrastructure work.

"In other developments, the developer is delivering lots and we're buying 30 or 40 from day one. We're just writing the check and the bank is providing the financing. There are other places where we are putting down earnest money and just taking down lots as we go," French says.

Playing the post-recession land game is much more sophisticated than the drive-until-you-qualify days before the housing market crash. When almost anyone could qualify for a mortgage, too many builders pursued market share by grabbing land, even subprime locations that were more than an hour's commute from where everyone else wanted to be, and built spec houses just because they could. Too many developers and speculators contributed to their own demise by putting too many lots in the dirt and taking on too much debt. A common caveat offered by builders who survived and thrived since the downturn is: Manage your debt.

Here are other strategies for playing the land game.

MAKING THE LAND WORK FOR YOU

Here are a couple of approaches that builders use to match product with land.

Featuring a breadth of product — Having a diversified product line can help, says Matt Ivey, of Ivey Homes, in Evans, Ga. A range of house plans provides builders the flexibility to either look for land with the characteristics that fit well with their existing product line and target market and/or match product and buyers with the land that is available.

Finding breadth within a community — Finding two to four different product types within the same community isn't unusual for developments built by Summit Custom Homes, in Lee Summit, Mo., which builds a house type in separate pods or a particular area within the development. "We make it a point to understand the demographics and psychographics of our buyers and to develop a community with product that meets a broad spectrum of lifestyle and income metrics," says Fred Delibero, CEO. "We don't so much say, 'This is our product and price point, and now what piece of land supports it?' Rather, we look at land that we identify as available, do our due diligence, and ask what product and price points work for buyers on this land."

Distinguishing needs from wants — Your buyers want 2,000-square-foot homes for $200,000 at close-in locations, but land availability and pricing will not allow that. Analyze that buyer group and ask: Would those customers trade off a shorter commute for a bigger house with a bigger backyard at the same price? "Start modifying, and take the list of all their wants down to what they need, and try to deliver a product that meets their needs more so than the list of wants," Ivey says.

THE BUILDER/ DEVELOPER MODEL

Columbus, Ga., the home market of Grayhawk Homes, used to have an active community of land developers. Their numbers have dwindled since the recession and Grayhawk founder Dave Erickson today either self-develops his lots or is the lead partner in several land development projects.

"Our home base has a relatively small and less sophisticated market in terms of developers, so you've got to do something to figure out your supply chain [for lots], otherwise you'll have difficulty staying in business on a consistent basis," Erickson says.

Being a developer in Columbus is "tricky," he adds, because there is the task of installing sewer lines and other infrastructure, which can be complicated by the jurisdictional boundaries of various municipal and county authorities, as well as the tight availability of subcontractors to develop the land. However, finding buildable lots is much easier in Des Moines, where Erickson expanded starting in 2011. The western edge of the Iowa city is a much more mature market for lots, and a robust community of developers provides most of what's needed.

"In both locations, we have a steady supply of lots available to us," Erickson says. "And as lots are offered to us in Des Moines, we'll say either yes, this is worth adding on to or no, it's not. That decision has to do with location, the type of product, and the price, so we're not desperate to get lots. We're keeping about a year or two years of lots in front of us, so we're unlikely to be short on lots all of a sudden. In Columbus, where we are a developer/builder, we have a good pipeline of land available."

Ivey Homes used to buy the majority of its lots from developers who were predominantly real estate brokers in the Augusta, Evans, and Grovetown, Ga., markets. That model was advantageous for brokers as they collected both on the sales of the land and the finished house. But a couple of years ago, banks changed their requirements for financing lot purchases and demanded more cash up front from builders.

"We looked at it and said if we have to put that much cash on the lots, why don't we put that cash into the land, self-develop it, and have more control over the process," says Matt Ivey, co-owner of the builder, which is based in Evans, Ga., and also builds in Aiken, S.C.

Mark Ivey, Matt's brother and co-owner, is a civil engineer and already very familiar with the land development business, which provides the company with a unique expertise. Although land developments demand a tremendous amount of cash, the Iveys found investors who are not interested in participating on the operations side of the home building company. So the brothers run two separate businesses—land development and home construction—and share the risk and the return with outside investors.

Self-developing their communities provided Ivey more control, compared with building in a development as one of several builders all being served by the same site team. In that scenario, Ivey's plans for product pricing, spec house inventory, and presale activity were competing for attention with the other builders.

"It was very difficult in some instances to have the site teams take advantage of what we offered with our operations system. Now we are in communities where we have site teams that are either direct employees or third-party employees working directly for us, and we can train them on our systems," Matt Ivey says.

THE BANKERS' LAND PERSPECTIVE

Some builders report that financial institutions in their markets are just now showing interest in participating in land transactions. Before the recession, Erickson offered banks that financed his land and lot acquisitions the first shot at his construction loan business. That arrangement stopped when credit tightened during the downturn. Erickson paid off all his land loans then, and the land he has acquired since is paid for. So even though more bankers during the past nine months have been calling to talk about land acquisitions, he hasn't pushed them yet to tie construction lending with development loans.

Fred Delibero, CEO of Summit Custom Homes, saw banks in his Kansas City, Mo., market loosen the development purse strings just for new phases in existing communities in 2011 and then for developing new communities starting in 2013. Lenders have told him that they prefer financing developer/builders rather than spec lot developers because they are more comfortable with the odds that builders like Summit will put a finished product on a parcel and monetize it.

"If you don't have experience and a track record developing, you can forget about financing," Delibero says. "We have experienced an increase of interest from lenders ready to make development loans again, and we are seeing banks compete against each other with more favorable terms, including lower interest rates, lower origination fees, and less cash in by the developer. The same holds true for vertical construction."

In addition to also owning undeveloped ground, Summit buys scattered lots from developers as needed and pods of lots with performance deposits and takedown schedules. Delibero expects to close between 225 and 250 homes this year with 60 percent of that volume coming from its exclusive communities. That means he'll need between 135 to 175 lots in 2015.

"Our goal is to control a five-year lot supply based on current economic activity, and we are close to that number," Delibero says. "We're also trying to bring on new communities at a rate of two a year and transition more of our total business to our own communities, so we're constantly working on filling that pipeline. If we get a little too heavy in one location, we'll consider opening up some lots to other builders."

THE HOMETOWN ADVANTAGE

With their cache of capital, national builders typically have first dibs on the prime acres of dirt, particularly with institutional landowners and large developers. But scoring a land deal ultimately can be the local builder's game given that the faces at a local builder probably have been there for years, while managers at the nationals come and go.

"When you have a good, ethical builder who has been in the local market for a long time and developed those relationships with developers and landowners, there is a high amount of trust, particularly if those are the builders who tended not to walk out on land options," says Mark Drumm, chief risk officer for Stratford Land, a Dallas-based company that operates a land brokerage division and recently launched a land investing fund with $1 billion in assets. "The publics with this kind of scorched-earth, turn-and-run approach when the downturn hit left a sour taste in people's mouths. The developers and landowners who survived, they have a long memory."

Recently, a subcontractor who worked for Grayhawk 12 years ago contacted Erickson regarding a cousin who was interested in selling her property near Columbus, Ga. He introduced Erickson to the owner days later, and the builder

eventually wrote an offer with a few contingencies. Erickson has had several acquisitions that started as simple inquiries decades ago and turned into a contract when the owner finally reached the day he or she was ready to sell.

"It will be a long day before that will happen in those instances with the bigger guys being a first option," Erickson says.

Keith Jacobs is president and chief operating officer of Jacob Companies, a third-generation family builder in Deerfield, Ill., started by his grandfather. When he was 16, he worked after school for his dad doing odd jobs when the company was building a 50-home community next to a horse stable. The teenager became a regular sight and very friendly with the stable owners who had declined previous overtures from his dad and grandfather to sell. Thirty years later, the stable owners phoned Keith to tell him they were ready to sell.

"It's a coincidence, but we do have relationships with some of these landowners who have been around a long time," Jacobs says. "My grandfather or father might have approached them at one time; they remember us, and we're an easy phone call because we are here on the North Shore (of Chicago). We also get a lot of referrals from local lenders that have pieces of property that they don't know what to do with."

As a teen, Jacobs accompanied his father, Marvin, to zoning board meetings and watched him in action. Now he's an insider, as Jacobs knows what municipal officials want for subdivisions and infill sites in their town, and they know that his company will deliver what it promises. Indeed, his team of attorneys, land lenders, and engineers who submit applications and proposals for zoning and permits are the same people who worked for his father.

"With the out-of-towners, if I went to one of their markets, I would be as wide-eyed as they are coming into one of our markets," Jacobs says. "I would have to relearn the whole process. It's like speaking a foreign language, and I speak the language here fluently. That's why we stayed in our niche, and why we've been so successful."

LAND COLLABORATION

Drumm observes that more developers are protecting themselves from the home building industry getting ahead of the market, as it did during the last bubble. Builders and developers are working together to get a better read on projecting what the absorption rate or anticipated demand will be for the community, whereas previously developers would meet huge takedown schedules for lots in order to satisfy builders' thirst for market share. This time around he sees profitability rather than the pursuit of market share driving land deals, resulting in schedules that are being done in smaller phases.

Before the crash, Kansas City developers typically would spec develop in phases of 30 to 60 lots and sell those parcels to an assortment of builders who bought as they needed them. Today developers still are spec developing lots, but they're working with a select group of leading builders that collectively can take down an entire phase of development. That approach effectively shuts out smaller builders from the "A" and "B" communities in the busiest parts of the metro market as well as Overland Park and Olathe, Kansas, Delibero says.

"This approach then creates a large cash flow to those developers to finance a repeat of that process," he adds.

Drumm also sees more land option deals that include true ups. These are arrangements where land seller and builder agree on a sales price and on an incremental adjustment based on an agreed upon home-to-lot ratio formula. So for instance, if the real estate market becomes more robust than expected and the builder sells a house for more money than projected when the land contract was struck, then the builder owes the developer more money for the land based on the difference between the closing price and the anticipated selling price multiplied by the agreed upon home-to-lot ratio.

"That is how some builders are getting conservatively priced lots and allowing the market to take the pricing from there rather than the developer walking the plank by themselves. The builder and developer are aligned and working together, and the developer gets a really fair price for his land," Drumm says.

When asked what land strategy lessons were learned from the downturn, managing debt and don't leverage heavily unless you can use the land in a very short time frame were common answers. Delibero wasn't buying land before the crash, but he watched a lot of companies go under. Lesson one for him is: Be able to build your way out of a downturn. Second: Don't buy land before you've performed your due diligence and figured out what it will cost to develop.

"Development isn't a high-margin game. and just a few mistakes or miscalculations can result in a much different return than projected," he says. **PB**