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Brokers Report Spike in Land Bids by Homebuilders

Finished lots in areas still seen as viable attract interest throughout state

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Land brokers in California are seeing something they haven't seen in well over a year - homebuilders, primarily the publicly traded ones, submitting bids for finished lots.

Brokers say this is happening even as homebuilders continue to shed lots in nonviable homebuilding markets.

Consider: At the end of 2008, Steve Reilly of **Prudential California Realty** in Danville helped **Meritage Homes** purchase 30 finished lots in Woodland, one of Sacramento's better-performing markets, and 48 lots in the east Contra Costa County city of Oakley. According to Reilly, at the same time the builder was buying these two assets it sold two other assets in Vallejo, one of the Bay Area's hardest-hit areas, and Plumas Lake, an outlying area north of Sacramento.

"What they're doing is selling their non-core assets in areas where they think the housing market is going to take longer to recover," Reilly said, "and buying in the more core regions where you could still build a house today and make a profit if you buy the lots cheap enough."

Similarly, Reilly said **D.R. Horton** - a net seller at the end of 2008-- just struck a deal to purchase lots from a landowner.

"Meritage was first out of the gate and D.R. Horton was second out of the gate," he said. "What we're seeing now is that it's everybody - **Lennar**, **Toll Brothers**, **Richmond American**, even **Standard Pacific**. Everybody is back in the market now, trying to find lots."

According to Tom Reimers, president of Irvine-based **Park Place Land Advisors**, several dynamics have converged to create a pocket of demand for lots in an otherwise bleak economic environment. He noted homebuilders have spent the past couple of years purging their land inventories to move assets off their books and recapture tax benefits.

"Now they find themselves in a depleted land situation, as far as lots that are ready to build on right now," Reimers said.

For homebuilders, whose business plan is to build and sell homes, this could result in a crisis - an identity crisis, that is.

"They're going to be a homebuilder without any lots to build," he said. "If they can't build and sell homes, they're technically no longer homebuilders."

They need to keep some level of operations going, he added, because if they're not building homes they'll have to continue laying off employees "and essentially go out of business."

Norm Scheel, principal and co-owner of the Irvine-based **Hoffman Co.**, is seeing the same thing.
"I wouldn't say it's in all markets, but there are certain geographic areas that are supply constrained," Scheel said. "That's really where they're going out there and buying."

For example, the Hoffman Co. marketed 96 finished lots in Riverside and had 10 publicly traded homebuilders pursue the property. While Scheel was surprised to have so many bidders for the project, he said his firm is getting 20-plus offers on many of the properties it's taking to market now.

"We're seeing similar activity in the north San Diego markets of Carlsbad, Vista, San Marcos and Oceanside, where there are very few opportunities and a real tight supply of finished lots," Scheel said. "We wouldn't see that same phenomenon in San Jacinto, Hemet, Beaumont or Banning. But in A locations, the publicly traded homebuilders are very aggressive."

Distressed but Still Competitive

With California recording more foreclosure filings than any other state during the first half of the year -- 391,611, or one for every 34 households, according to **RealtyTrac** - no one is claiming there still isn't a lot of distress in the housing market. But from a finished-lot standpoint, the market is tighter than one might expect.

Reimers pointed to a growing scarcity of finished lots in the marketplace. That's another factor driving this buying activity - the supply of finished lots is being exhausted because no one is making any more of them.

"Once these finished lots are gone, they're gone," Reimers said. "The pool isn't being replenished because there's no capital to replenish them."

In most instances, he said, it isn't feasible to take an undeveloped lot and do the so-called horizontal development needed to build a home on it. The development costs are higher than what the finished lot would be worth.

"You can't produce the lot at a number that's below the finished lot value," Reimers said, "so it gets into that negative land residual that everyone likes to talk about."

Buying finished lots enables homebuilders to get their raw materials at less than replacement cost value. To illustrate, Reimers said finished lot prices in Hemet peaked at nearly $150,000 per lot and now range from $40,000 to $50,000. Meanwhile, the development cost to turn a raw piece of dirt into a finished lot is in the $60,000 to $80,000 range.

So much for land residual.

But in more established areas such as Corona or Eastvale in unincorporated Riverside County, lot prices peaked at around $250,000 per finished lot and got down to $85,000 to $95,000 per lot. With this recent uptick in builder interest, however, Reimers has seen properties go into escrow above $130,000 per lot just in the last few weeks.

Contributing to the depletion of lots, he said many homebuilders over the past 90 to 120 days have seen an uptick in absorption, which means they're moving their lots faster. Reimers credits the fact that overall prices have come down far enough to where homebuyer demand has kicked in a bit, as well as the inclusion of the tax credit and other stimulus elements that have rewarded people for buying new homes. The good news is that homebuilders in this situation now are opting to refill their pipelines. And they are able to do so at prices that are a fraction of what they were paying a few years ago.

Reilly said Meritage paid $40,000 per lot for the lots in Woodland.

"The previous builder who had them paid $150,000 a lot before they put in the infrastructure," he said "Meritage bought those lots for less than the infrastructure cost."

Public Advantages

The buying activity for finished lots primarily is coming from the publicly held homebuilders, although earlier this year Reimers sold to a private builder a project in Chino Hills consisting of three standing-inventory homes, four model homes and 25 finished lots. The seller was **GMAC**.

"The person who bought it was a relatively small private homebuilder who came in, bought the site and managed at the time to get a construction loan, which is really the major thing that's keeping most private homebuilders from participating in this purchasing activity right now," he said.

You can count on one hand the number of financial institutions that are making construction loans for vertical construction of homebuilding projects right now, though. Reimers said the public homebuilders are able to finance their vertical construction internally, because many of them are sitting on significant amounts of cash in their balance sheets.

"That is a major reason that the public homebuilders are able to move right now," he said. "If they were subject to the same construction finance market that the private and smaller builders are, they wouldn't be out there doing this either."

The rub is that for the past couple of years homebuilders have been far more likely to get rid of their dirt. But as Les Whittlesey, a principal and co-founder of Irvine-based **Whittlesey-Doyle**, pointed out, most of the lots they're trying to unload are in markets where it wouldn't make sense to build in today's market. "A lot of the holdings they have are in the outlying areas that you really can't build on," Whittlesey said. "Most of the finished-lot buying is closer in, which means the west end of the Inland Empire, L.A. County, San Diego County, Orange County. Most of those are infill areas where there's less foreclosure."

It's a strange dichotomy, Reimers acknowledged. A year or so ago, he said, these same builders were trying to get their final tax clawbacks or net operating loss carrybacks by selling lots they had in their inventory.

"It's a weird twist of fortune," he said, "but in order to maximize the cash coming back to these companies, it was something that was necessary."

The general trend for most of these homebuilders, he said, is to upgrade the quality of their lot inventory. That means they're selling lots in secondary and tertiary markets and now are looking to purchase lots in the primary markets or the first tier of secondary markets.

"They weren't selling lots in Hemet and replacing them by buying lots in Hemet," he said.

Downsized Spaces Gain Appeal

Despite the dismal numbers for home sales, the brokers assert that builders are buying lots now with the intention of getting projects approved and to start building as soon as they can.

Whittlesey cited the long lead times in the homebuilding business.

"There's a lot of belief that this year should be the bottoming of the market for the residential sector," he said. "If a builder bought a set of finished lots today, it's a minimum six and most likely nine months before they have a model complex open on that project."

However, they're planning smaller product, homes with smaller square footages, so they can compete with foreclosure homes. Scheel said they'll run their pro formas to the foreclosure market, so they're selling a new home at virtually the same price as a foreclosure.

"If the bank-owned foreclosure houses are selling for $150 a foot, that's exactly the price these builders are going to be coming in at," he said.

Reilly agreed.

"If they can get the price close but deliver a brand-new house that has a warranty," he said, "a buyer will buy one of these houses rather than a foreclosure down the street."

He said the homes Meritage plans in Oakley will be about 1,400 square feet, whereas the smallest-size home in that market previously was close to 2,000 square feet. In general, the average-size home has decreased by 500 to 1,000 square feet and on larger homes by as much as 1,000 to 1,500 square feet, he said.

Land brokers view this as still being the early stages of the new trend. But it's one they expect to see more of over the next few years. Whittlesey noted his firm is working with lending institutions to obtain agreements to market their properties.

"A lot of the assets in the better locations really haven't hit the market yet," he said.

And Reimers said many of the homebuilders that are interested in buying lots have not gotten past the offer and due diligence stage. Still, his firm has a handful of deals in escrow with builders.

"They're spending the due diligence dollars and putting projects under contract," he said.

Reilly said the builders he works with in Northern California are shedding assets in the Central Valley and focusing their buying activity on the A locations in Sacramento. But they're saving their real spending power for the time when assets in the prized Bay Area start to hit the market.

"That's where they're going to deploy the big chunks of money," he said.

He said that for the most part, builders at the moment are looking for little projects to tide them over so they can cover their overhead and keep the electricity bill paid.

"They're buying small deals, 20, 30 40 lots at time," Reilly said. "They can be in and out of a community in a year or two, about the time when the really good deals will start showing up. When you're a builder, everything looks like a nail and you're a hammer."

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