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EXCLUSIVE

LAND PRICING MOVES AHEAD OF FUNDAMENTALS

By Natalie Dolce
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SAN FRANCISCO—Every year during PCBC, real estate law firm Cox Castle Nicholson—along with its co-sponsors The Concord Group and Ernst & Young—conducts an executive roundtable of 30-40 leaders from the building industry to discuss a wide range of land use, financing and economics, regulatory, and business topics. The roundtable brings together developers, investors, bankers and financiers, and other industry players to share intelligence and perspectives on the state of the industry.

Now in its fourth year, the roundtable covered issues around the current condition of the capital markets, investment patterns of private versus public developers, the impact of for rent multi-family, trends around land use and entitlement, and more.

Matt Wyman, a partner in Cox Castle Nicholson's San Francisco office and a charter member of the planning team for the Land & Capital Conference at this year's PCBC, offered GlobeSt.com with an overview of the top pacing issues that were discussed:

GlobeSt.com: What is the perception of the state of the industry?

Matt Wyman: The general sense from attendees was the overall economy is improving. Interest rates remain a concern. Looking at timeframes, there was strong optimism for positive industry growth in 2015, 2016, and 2017. After that, there is more uncertainty. Often times, we use a baseball analogy of "what inning are we in?" with respect to the economic recovery. Many at the roundtable felt as though we were in the third inning, some adding, after a rain delay all of last year. However, others noted that increased cost pressure on both land and construction costs has made it more difficult to underwrite deals as margins shrink.

GlobeSt.com: How are the capital markets responding to the tighter margin environment?

Wyman: The deal economics are shifting rapidly and dramatically. Many at the roundtable believe that land pricing has moved ahead of fundamentals. Some attributed this to heavy investor interest in the sector. Although others at the roundtable observed that such investor enthusiasm has plateaued. One response to the tightening margins has been to try to figure out a way to lower the cost of capital.

In this regard, banks are coming back mostly with recourse lending. However, they are still looking for guarantees and strong financials. While this dynamic is great for better capitalized builders, smaller/less capitalized ones have less access to capital and must go the investor and/or the non-regulated investor route. At the same time, those that provide non-recourse financing are taking a harder look at deals or moving into new markets where margins provide greater breathing room.

Participants at the roundtable observed that there is a great deal of competition between public and private companies for land, and some perceived overpaying happening. However, it was not always the case that the publics were the highest bidder. Ultimately, many at the roundtable felt that developers and investors are going into deals with either a little more “hair” on them or less well established markets, assuming more risk, but hopefully achieving greater returns.

Multifamily developers are feeling the impact of higher land costs as well. Many can no longer compete with homebuilders for land except on higher-density housing projects.

GlobeSt.com: Where are developers getting capital?

Wyman: Participants at the roundtable observed that the primary sources were regional banks on the debt side and institutional investors for equity. One participant observed that he is seeing some seller financing, although it was unclear if this just meant taking back-end profit participation as opposed to the actual base price of the land.

GlobeSt.com: What are the hot markets where developers are investing?

Wyman: Among the attendees, the top markets where they see opportunity are the Bay Area/Silicon Valley (which everyone agreed was an exceptional market) and—more broadly—California; Seattle; Washington, DC metro area; some Arizona markets; tri-state New York area; and the top cities in Texas. The participants noted that these opportunities for the most part directly correlate to strong job growth and real population growth.

Participants at the roundtable noted that in markets where it is difficult to find land, developers will “re-purpose properties,” purchasing underperforming retail centers, mobile home parks, or industrial properties, then re-entitle them for residential. One developer relayed a story about an industrial site that his company pursued. It was entitled for residential and had 12 bids contingent on the entitlements and two of them, however, were not contingent. Asked about the premium for the entitlement conditioned deals, the participant estimated that it was about a 50% increase.