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For Sale: Institutional investors snapping up residential land

Many see move as way to bolster their returns

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Institutional investors are buying up heavily discounted land reserved for residential development.

Residential land nationwide is now estimated to be worth 25% to 33% less than it was two years ago. The value of some properties has been reduced by as much as 75%, real estate experts say. Investors' current interest in residential land is a departure from traditional institutional investment in commercial real estate that is close to fully leased in primary real estate markets.

“I think it's an historic opportunity,” said Joe Blackbourn, president of Everest Holdings, Scottsdale, Ariz. Everest is the managing partner of Everest Market Street Investments LLC, a $125 million joint venture with real estate investment management firm DivcoWest, San Francisco, to invest in residential land. The $240.6 billion California Public Employees' Retirement System, Sacramento, invests with DivcoWest.

“The market was very overinflated. There was truly a bubble. It could be a buyer's market until 2010 and 2011,” Mr. Blackbourn said. “In the meantime, builders have a tremendous inventory problem.”

Several real estate investment firms now are starting to invest in residential land. They range from firms raising specialized distressed residential land funds such as Everest Market Street and TriPacific Capital Advisors LLC., an Irvine, Calif., a spinoff of Lowe Enterprises Inc., to firms investing their main real estate funds, such as Prudential Real Estate Investors, Colony Capital LLC and Blackstone Group.

Way to increase returns

Many institutional investors see residential land as a way to boost returns.

Large institutions — including the $173.7 billion California State Teachers Retirement System, the $41.3 billion Los Angeles County Employees' Retirement Association and the $17.1 billion Stanford University endowment — already have committed capital to residential land funds. Sacramento, Calif.-based CalPERS committed a combined $121 million to two funds managed by longtime investment partner Resmark Equity Partners LLC.

CalSTRS has set aside $1.5 billion for residential land, but only about $200 million has been invested so far, said Sherry Reser, CalSTRS spokeswoman.

John D. McClelland, principal investment officer, real estate, at L.A. County, said his fund has invested $137 million of a $300 million commitment to TriPacific.

“In this market, every deal is a distressed land deal,” said Sean Burton, partner, chief operating officer and managing director of CityView, a Los Angeles-based real estate investment firm co-founded by former U.S. Secretary of Housing and Urban Development Henry Cisneros.

CalPERS, Los Angeles County, the $11.1 billion Los Angeles City Employees” Retirement System and the $16.6 billion Los Angeles Fire & Police Pension System are investors with CityView, which focuses on urban housing.

In the last six to eight weeks, banks and private equity firms are pressuring residential developers to sell their undeveloped land at a discount, Mr. Burton said.

“We're looking at deals where the land is not worth what developers paid for it two years ago,” Mr. Burton said.

Between 1999 and 2006, publicly held homebuilders spent $160 billion on land. Now, as new home building has slumped, they are trying to unload some of that property. Up for sale is raw land as well as building sites complete with water pipes, electric lines and other infrastructure.

Troubled developers are starting to remove large portfolios of land from their books at a fraction of their value.

In January, Resmark acquired 604 home sites in Southern California for $90.6 million from William Lyon Homes, Newport Beach, Calif. According to information filed by William Lyon with the Securities and Exchange Commission, the properties had a book value of $210.7 million. That values Resmark's deal at about 43 cents on the dollar.

William Lyon Homes' suffered a net loss of $349.4 million last year because of a net 16% drop in new home orders, according to an earnings report issued Feb. 27. A year earlier, the company reported a net gain of $75 million.

In November, the country's largest homebuilder, Lennar Corp., Miami, sold 11,000 home sites to Morgan Stanley Real Estate, New York, for $525 million. The properties had a net book value of about $1.3 billion as of Sept. 30.

“There's more to come in 2008,” said Nick Masich, managing member of Pomona, Calif.-based real estate investment firm ION Capital Partners LLC. “There's a lot of home builders trying to do another Lennar and Resmark. ... We were looking at land valued at 25 cents on the dollar.”

Those price reductions are creating a potential bonanza for institutional investors. But investments in residential land and land development are much more speculative than investing in, say stabilized commercial real estate, where expected returns are anticipated to moderate from levels approaching 20%, said Scott Farb, managing principal in the Los Angeles office of Reznick Group PC, a real estate consulting firm.

“Investors are hoping to invest where the next wave of opportunity will be,” Mr. Farb said.

“Pension fund are seeking higher yields from their real estate investments,” he said.

In addition to investing in distressed residential land, pension funds and other institutions are interested in distressed residential debt and real estate mezzanine debt funds, he said.

“Pension funds seeking higher yields from their real estate investments are now allocating capital to alternative, niche-based funds such as distressed residential land funds, that look for deep-discounted opportunities to buy large land parcels and finished lots, as well as loan portfolios that lenders are trying to remove from their books,” Mr. Farb said.

His firm has been working with several large opportunistic land funds, pension funds and other institutional investors in this area. They are “seeking transactions to take advantage of the dislocation and dramatic changes that have occurred in the residential marketplace since last August,” he said.

But investing in land, even finished lots ready for home construction, is risky. “You have to be patient and hold the property for a significant amount of time,” Everest Holdings' Mr. Blackbourn said.

Treading carefully

Most investment firms now just starting to look at residential land are interested primarily in ready-to-build property with infrastructure already in place. But “there are just so much finished lots,” Mr. Blackbourn said.

That is why experienced real estate investment firms are only gingerly dipping their toes into these waters.

“There's a lot of people circling the space looking for opportunities,” said Allen Smith, chief executive officer of Prudential Real Estate Investors, Newark, N.J. “We've been looking at residential land, but we have approached it very selectively.”

Prudential executives decided to pursue opportunities selectively rather than buy vast portfolios at deep discounts and cull through them for the gems. And instead of launching a specific fund, Prudential is investing in residential land through its diversified real estate funds including its $12.5 billion PRISA I fund, the firm's core fund.

“The opportunities we have pursued are very project-specific. We look at projects in which we are comfortable with the prices and the returns, rather than the law of large numbers,” Mr. Smith said.