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Addressing the Distressed--Part II

Source: BIG BUILDER News
Publication date: 2008-07-02

By Peter Dennehy

In a morning session on buying land and large distressed planned residential projects, principal of land brokerage firm O'Donnell/Atkins Mac O'Donnell presented some data on recent land sales and portfolio transactions in Southern California. In the Inland Empire, any transactions taking place are at significant discounts to the value of the improvements.

Overall, Inland Empire residential lot values are down 50% to 70% from peak values, and paper lot values are "negative" in some of the periphery markets where there is no current demand for homes or lots. In the Temecula submarket of Riverside County, finished lot values for a 7,200-square-foot lot are currently at $125,000 versus $270,000 at market peak in 2005, and are thus back at 2001 and 2002 lot price levels. In terms of how long it can take to regain past peak levels, lot prices in that market hit peak levels of $75,000 in 1989 before starting to decline and took almost 10 years to reach that level of lot price again in 1998.

As on Day 1 of the conference, there was discussion of the disconnect in the amount of potential distressed deals taking place and the bigger wave of such sales expected in the future as banks get serious about selling assets. Most of the limited sales to date have involved either public builders selling unwanted projects or banks selling notes in bundled portfolios--and the quality of the offerings can best be described as "inconsistent."

There is little comprehensive information for available properties, which makes it hard to assess value, and market conditions are continuing to deteriorate. Other practical constraints for potential bidders are out-of-date appraisals, limited staff, and little to no information on the current situation at a particular property, all in the context of short timeframes. With respect to appraisals, if there is one, it is likely unrealistic in that it assumes "Fair Market Value" between a willing seller and a buyer who has options to finance and develop it in the near term, rather than the liquidation mentality that prevails in today's stalled land and homebuilding market.

In a panel discussion involving bank regulators and Federal Reserve representatives, there was a sign that the government is aware of the inertia in the resolution process. Sabeth Siddique with the Federal Reserve presented statistics that while residential loan delinquency rates are up, there is more to come. Banks are still delaying the inevitable by using loan reserves to make loan payments, and a focus on asset quality is needed, according to Siddique. In his view, regulators would intensify pressure on banks. While he did not see regulators asking banks to price loans at low-bid levels, he suggested that banks should be more transparent in their loan value rationale to accomplish deals with a skeptical investor community.

Other panelists with experience in the RTC process in late 1980s and early 1990s reminded the audience that there is no quick fix and that the "mark to market" process then took almost a decade to set up, staff, and work through the divesting of distressed properties. While nobody would say that an RTC-level of institution would be needed, there could certainly be a need for a temporary, smaller structure to manage the process. For those buying assets today, there was a reminder that the assets they are acquiring need active management to maintain value and preserve entitlements. In most U.S. markets with good fundamentals in the next five to 10 years, there is a shortage of residential and commercial land with entitlements and utility access in place--and proximity to job concentrations is key in this era of high energy costs--so a realistic view of value should include the value of the ability to develop itself.

To conclude, one was struck over the two-day conference by both the similarities to past development downturns and how they worked themselves out--"gun shy" builders moved to not owning land as the market stabilized, the "mark to market" process taking some years to happen, etc.--and how a unique set of economic and market issues are facing the industry at this time. What is clear is that confidence needs to be restored in the land purchase process and in valuation (perhaps through better information and communication); that a longer-term investment perspective would be more useful to adopt in considering opportunities today; and that a more comprehensive plan to address the economic, employment, lending, and consumer psyche issues facing us is needed to overcome the current inertia that is preventing us from moving forward.

<i> Peter Dennehy is senior vice president of Sullivan Group Real Estate Advisors. He may be reached via e-mail at p.dennehy@sgrea.com. </i>
