COLDWELL BANKER COMMERCIAL

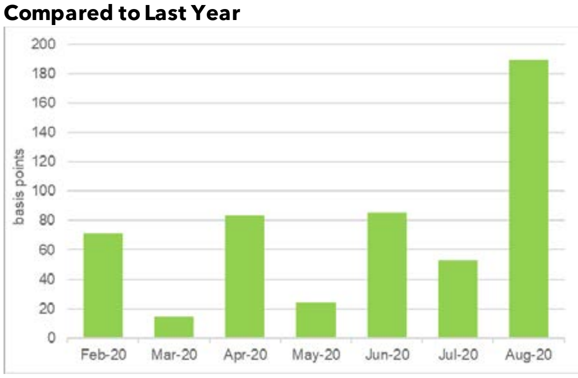
What's been driving land sales for residential development during an economic recession?

The U.S. economy entered a recession in February 2020, per the National Bureau of Economic Research. Commercial real estate development typically slows during a recession because developers do not want to incur the holding costs of land parcels if there is not an expected demand for new product.

While land sales for office and retail development have slowed because of the uncertainty in these property sectors, land sales for residential development have accelerated in line with the increased demand for housing in many markets. Unlike the 2008 recession, the current economic downturn is not led by real estate and housing.

The uptick in sales for residential development property since the coronavirus outbreak is notable. Builders are acquiring land at a swift pace, with most states seeing a higher percentage of their total land sales earmarked for residential development compared to the prior year (Exhibit 1).

Exhibit 1: Average Increase in Percentage of Land Sales Marked for Residential Development Compared to Last Year



Source: CBC Research, CoStar data.

The country's largest homebuilders pulled back on land purchases and laid off workers in March and April due to the high risk in holding large land parcels for hundreds of homes (see Exhibit 2).

Private developers, however, who build on a smaller scale never stopped buying land or looking for projects – save for momentary nervousness during the COVID shutdowns in March. After regaining confidence in April, many regional builders were back to closing deals in order to satisfy the unexpected demand for housing, buttressed by low interest rates, peak millennial home-buyer age, and changes in housing location preferences due to the COVID economy.

Exhibit 2: Public Homebuilder Announcements

Builder	Response to COVID-19
Hovnanian	1. Cut $20M in cost through furloughs, layoffs, other measures; expect $3M severance charge in 3Q20. 2. Delaying land purchases, land development activity, and working on unsold homes to preserve cash.
Pulte Group	1. Cut $100M in cost through layoffs, furloughs, salary reductions; expect $10M severance charge in 2Q20. 2. Quickly modified sales, construction & administrative processes in response to a demand slowdown in March.
D.R. Horton	1. Near-term hiring freeze; market-by-market layoffs. 2. Limiting land acquisition & development spend; adjusting product offerings, incentives, home pricing, sales pace. 3. Temporarily stopped purchasing raw land; tightened finished lot purchases; adjusted the timing of takedown schedules to match current demand levels.
Green Brick Partners	1. Cut cost by $10.4M through salary reductions and layoffs. 2. Reducing purchases of lots/land; slowing land development spend on existing projects; halting expansion into new markets.
Lennar Corp	1. Pausing land acquisitions by extending the closing dates. 2. Reducing cash for land development; slowing start pace. 3. Pivoting to lighter and shorter duration land positions. 4. Moved down the price curve; have quick move-in homes.

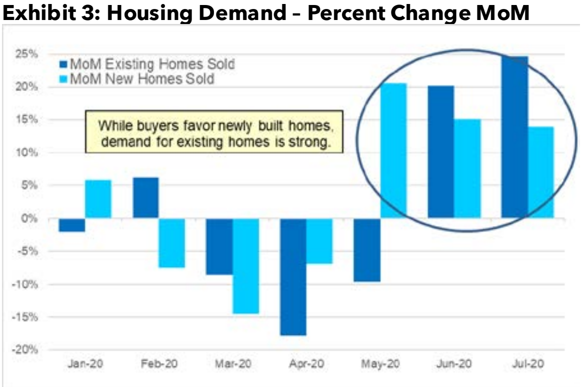
Source: CBC Research, SEC filings, Press Releases, Earnings Transcripts.

Private developers have been taking sites piece by piece (5-20 acres at a time) and funding the next plots of land with proceeds from pre-sale contracts and property sales.

Low Inventory + COVID Driving Demand. Unexpectedly strong buyer traffic and significant interest in new construction have been converting into sales at record rates and depleting already-low inventory levels down to just a month or two of supply in many markets (compared to 5-6 months for a balanced market).

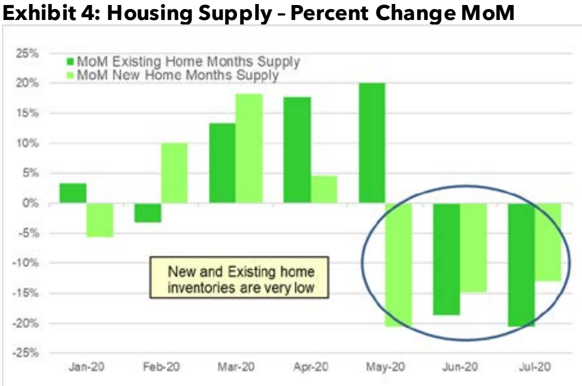
The supply of new homes for sale in the United States is currently down 33% year-over-year while existing home supply is down 26% from the prior year (both following a 2% decline in 2019).

Exhibit 3: Housing Demand – Percent Change MoM



Source: CBC Research, U.S. Census Bureau, HUD, NAR.

Exhibit 4: Housing Supply – Percent Change MoM



Source: CBC Research, U.S. Census Bureau, HUD, NAR.

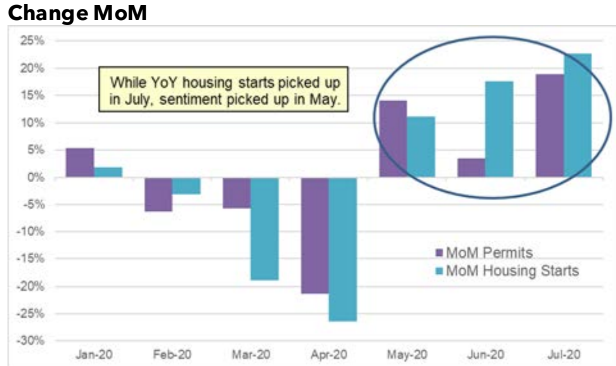
Sellers remain reluctant to return to the market, with fewer homes being listed. For sale inventory across the country decreased 36.4% year-over-year in August following a 32.6% drop in July. States and regions that saw the biggest inventory declines this summer include Maryland (-55%); Atlanta MSA (-54%); Indiana (-51%); California (-48%); and Charlotte MSA (-48%) – according to NAR and each state's Association of Realtors.

Metros with homes that sold the fastest compared to last year include Hartford-East Hartford (-19 days); NY-NJ-PA (-18 days); Virginia Beach-Norfolk, VA (-18 days); Philadelphia MSA (-15 days); and Raleigh, NC (-15 days).

Home prices are experiencing upticks across the country, despite the recession, with 96% of U.S. metros seeing year-over-year gains. The biggest increases were in Huntsville, AL (+14%); Memphis, TN (+13%); Boise, ID (+13%); Spokane, WA (+12%); Indianapolis, IN (+11%); and Phoenix, AZ (+10%).

The lack of supply and ensuing demand have resulted in increased competition for land among builders, who are attempting to ramp production up quickly. As such, there has been a marked increase in building permits and starts (Exhibit 5). Homebuilder sentiment in July jumped 14 points to 72, returning to pre-pandemic levels, despite a recessionary economy.

Exhibit 5: Housing Permits and Starts – Percent Change MoM



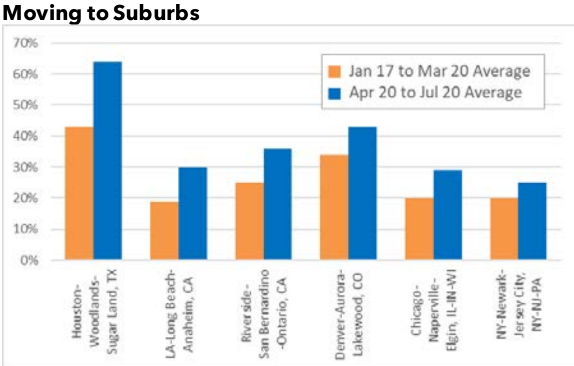
Source: CBC Research, U.S. Census Bureau, HUD.

Builder sentiment saw the biggest bump in the Northeast (+22 points) and Midwest (+18 points) as they benefited from pent-up demand that had been sidelined by lockdowns in the spring. Builder confidence in the South and West also increased (+10 and +14 points, respectively).

While migration to the suburbs is not a new trend, it became more pronounced this summer after months of sheltering-in-place created a desire for more space, and the likelihood that more people will work remotely. As a result, we expect the trend to suburban markets where single family home demand is greatest to continue as the work-from-home lifestyle becomes standard in the near-term and employees adjust to COVID-related flexible work models.

New home demand is rising in lower density markets, including small metro areas, rural markets, and large metro exurbs adding to the increased demand for land. Record-low interest rates should continue to support mortgage applications for new homes (+54% in June and +39% in July year-over-year).

Exhibit 6: Percentage of Mortgage Applications Moving to Suburbs



Source: Caliber Home Loans.

Less Debt Financing.
For several years following the Great Recession of 2008, banks were reticent to make land development. When banks began to relax the reins on this money flow in 2013, demand for development land went up. By 2020, banks had tightened their lending practices for construction and development land once again – reducing loan-to-value by 20% in some cases and turning developers down in other cases. Paper lots with entitlements are favored and often the only types of deals getting loan approval these days.
Because banks are uncertain about the post-stimulus environment, they have been very slow to close deals. Developable land, not yet entitled, is unlikely to get bank approval.

Majority Financing with Cash.
Because most private builders prefer to buy land in phases, typically after securing a buyer for their last project, they are usually able to use their own cash (or roll over equity) to finance the next land deal. Consequently, developers will often ask for a takedown schedule for large tracts of land and offer big down payments. In a few cases, private builders will get financing with an established banking relationship.

Additionally, some secondary and tertiary markets are experiencing private investors loaning money to local builders for residential development projects (in lieu of investing in the stock market). In these cases, the land or property is used as collateral.

End Product.
We expect that demand for land with residential development potential will continue to rise from the incremental boost caused by home buying preference shifts resulting from the coronavirus. Developers are willing to build a variety of residential product: single-family homes, multi-family apartments, and townhomes.

After a pause in residential development activity in March and April 2020, commercial land sales for residential development accelerated to satisfy a new spike in housing demand. As a result, at a time in the economic cycle when commercial land sales would typically slow there is an increase in land sales for residential development. This is an anomalistic trend compared to commercial real estate land activity during prior recessions.

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