

Feature: Back To Earth

Lennar's clout gives its land divestures meaning beyond the terms of its transactions. The definition of "big" has changed.

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Less than a decade ago, Lennar Corp.'s meteoric rise to the top tier among America's home building companies came through a hard-won deal—the May 2, 2000, purchase of U.S. Home. Arguably one of the most acquisitive companies in the business during housing's prolonged run up, it should come as no surprise that a preemptive, first-of-its-kind blockbuster divestiture deal should figure so heavily in the Miami-based No. 2-ranked home builder's fight for long-term viability amid what's likely to be a stubborn period of contraction.

Nov. 30, 2007, may well become known as the day Lennar suddenly changed the game of big-time home building—and all its rules, too. While many home building strategists continued to measure how to slow growth in their organizations, Lennar was quietly devising a way to accelerate growth's opposite. Its rationale, consistent with a deal style mastered across scores of acquisitions, joint ventures, and sales over the past decade, was simple: Keep information closely-guarded, be the first to strike, and make a splash big enough to make people's heads spin.

In a transaction consummated and announced a few ticks shy of the end of its 2007 fiscal year, Lennar dropped 11,000 lots from its balance sheet, took in a half-billion dollars in much-needed cash, set up a claim for upward of another \$270 million from the Internal Revenue Service, and left a rather profitable mark on the very lots it was divesting. In a single transaction, the company sold dirt in eight states worth \$1.3 billion for \$525 million into a joint venture with Morgan Stanley Real Estate. Meanwhile, more regionalized Lennar land divestitures lit up the map one by one in the wake of the big deal, like aftershocks. They keep cropping up, suggesting that Lennar will continue to shed land where it can and when it can, using some newly minted internal rate of (less) return model to guide expectations.

Within the force-field of Lennar's announcements, a series of industry-wide ramifications play out:

1 Those who had been looking for the bottom of the asset value market can almost catch a glimpse. On the surface, the arrangement marks land to a market value of 40 cents on the dollar. As the first solid sales number that involved lots in a multitude of markets, the transaction has the power to potentially reset land values across the country and finally break the land price logjam that has kept sales stagnant.

2 Broader implications signal that there is confidence in the long-term viability of the real estate market as well as of land. Amid still hostile market conditions, Morgan Stanley's willingness to jump into such a venture underscores its conviction that the sharp knife of land prices may have finally hit the floor.

3 At the same time, the transaction wields the power to put some builders out of business. As book values reset along the price points of Lennar's newly adjusted rate card for land assets, builders with little cash immediately became powerless to bankers, as overnight they potentially owe more than their land holdings' adjusted worth.

4 Finally, there is the prospect of recouping tax money from the government. The deal sets the stage for Lennar to potentially pocket roughly \$270 million by applying 2007 losses against record-setting profits of 2005.

"Me, Too" Deals?

On the surface, the transaction with Morgan Stanley appears as a typical Lennar move: bold, crafty, and ahead of the crowd of other big builders who stood by similarly mired in the muck of the meltdown, mouths agape, some wondering if they could mimic it. "It's something that we and everybody have been looking at and will be looking at further," Toll Brothers CEO Robert Toll said during his company's quarterly conference call shortly after the sale was announced.

But in the two weeks that followed the deal—just as Big Builder was going to press—news of additional land sales began to come to light.

With its final quarter and year-end fiscal 2007 results yet to be reported, it's unclear whether the company is merely being very aggressive and smart in its moves, or rather, is driven by an urgent need for cash to avert calamity. Still, a closer look reveals what's likely to be the makings of survival tactics that will play out iteratively over the next year toward a strategy that differs diametrically from its high-growth model of the prior decade—an operational model mapped to a much smaller scale that might allow the company to hibernate through the barren months ahead and keep the debt that is tucked away in its joint ventures from doing harm to the balance sheet.

Trendsetter

In the Morgan Stanley deal, creative structuring lets Lennar keep a 20 percent share in the new joint venture. In addition, it gleans 50 percent of voting rights, 100 percent of management fees, a "disproportionate" share of the profits if the venture exceeds financial targets, and first rights to buy the land back in the future. In other words, it's quite arguably not an arm's-length transaction, except in a for-tax-purposes sense. For that reason alone, it's one that many admire as virtually brilliant.

"I would be very surprised if this deal is not replicated numerous times over the next couple of years, just like their LandSource deal was replicated," says Focus Property Group CEO John Ritter. "I think you'll see that Lennar has, once again, invented a new structure, and they will be copied."

A large amount of the buzz is specific to the tax recognition and its possible implications over the next year (see "Loss Leader" below). "From Lennar's perspective of generating cash, they are generating two piles: the \$565 million from the sale of the properties, and the government is, in essence, giving them a free \$265 million for doing some bookkeeping," says Barry Gross, a CPA and president of Developers Research. "That is a very dear asset."

Fitch Ratings senior director Bob Curran expects more companies to take advantage of the "claw-back" by yearend. And indeed, numerous dealmakers, advisors, and brokers report that the urgency in their December negotiations is incited by the tax break. "We actually are working on several year-end transactions, and the properties are being discounted by more than 50 percent in order to perfect the transaction," says Norm Scheel, president of The Hoffman Co.

According to financial records, Lennar had a 2005 tax provision of nearly \$800 million. Even after applying the approximately \$270 million rebate for the Morgan Stanley deal, that still leaves a lot of money on the table waiting to be captured.

That being said, news of other Lennar land sales were coming to light at press time—the most significant being the sale of 8,300 lots in Florida to Metro Development Group, which also closed on Nov. 30, the last day of the fiscal year.

In Delaware, Brookfield Homes assumed Lennar's joint venture interest in a 2,000-lot active adult community. In Long Beach, Calif., Lennar sold its interest in the SeaPort Marina partnership to Taki-Sun. Deals in Phoenix and Washington, D.C., were also reported. And local sources familiar with the transactions state that the prices were not favorable for Lennar.

Smoke and Mirrors

It's no surprise to Moody's Investors Services VP and senior credit officer Joseph Snider that Lennar is once again a trend-setter "because they generally try to look ahead and anticipate things, and they try to be responsive to the ratings agencies. We have expressed to them that we think they are top-heavy on land, and [second] we are uncomfortable with the level of joint venture exposure they have."

Which raises the question of how joint venture arrangements will ultimately play out as the downturn progresses. Gross at Developers Research predicts there is likely a payback coming due for keeping projects with a higher debt-to-equity ratio off the balance sheet. And he is not alone.

Analysts, credit ratings agencies, and activist shareholders tend to look at joint ventures with distrust—not because they are inherently bad, but rather because every deal is different, and it's seldom clear how much risk is rolled up in them. Ratings agencies frequently penalize the bond ratings of companies such as Lennar that use a lot of joint ventures, simply due to the lack of visibility.

In theory, the joint venture's benefit is to keep as much of the assets off of the balance sheet as it can. But according to accounting rule FIN 46, when a company makes a determination whether to consolidate or account for assets in equity and earnings, it also has to make several estimates. If the estimates later turn out to be wrong, FIN 46 permits the accountants to come back in and demand a company to restate those figures, which would require a reclassification to a consolidated subsidiary that has to return to the company's balance sheet.

If the joint venture was structured, as most are, with a high percentage of debt and a little bit of equity, that has the potential to throw the company's overall debt-to-income ratio off-kilter and possibly breach covenants.

Lennar is the most active user of joint ventures in the public home building group. According to an October report from Zelman and Associates, its JV investments represent 11 percent of the company's total assets, compared with a group median of 3 percent.

And in the creation of this new deal with Morgan Stanley, Lennar has hatched yet another elusive entity.

"There are some obvious benefits to the deal, and then there are some concerns that we won't know until later, maybe much later, whether they are problems," Snider says. "Even though [the partnership] is being portrayed as non-recourse, what we discovered from the Transeastern JV [with Technical Olympic USA] is that sometimes what is considered to be non-recourse on the JV level turns out to be full recourse when the JV becomes non-performing."

If this occurs, companies could be called to put more cash into the deal to keep the JV's credit in place. Since JVs can be much more highly leveraged than what a typical home builder could get away with, as TOUSA found out, that infusion requirement could be huge.

Another more direct result is that, in pulling the \$1.3 billion of land off its balance sheet—and likely more, given the other deals still surfacing—the sale will affect the company's assets, which could lead to the reduction of its revolving line of credit. "While they may not need it, it's nice to have heading into a continued length of hard times," says Snider.

Certainly, Lennar has been diligent in keeping its revolving line of credit mostly untapped and has built a sizeable war chest. But it has some big credit bills coming due over the next five years—\$828 million of debt, representing 73 percent of its earnings before taxes. According to Zelman's report, the group average is 27 percent.

Though the note closest to maturity is \$279 million due in February 2009, which is attainable given Lennar's current financial snapshot, the company's cash on hand and line of credit may not be enough if one of its joint ventures suddenly needed the kind of cash infusion TOUSA's Transeastern joint venture required.

Even as those who follow the residential building industry work to dissect Lennar's latest land deals, they also speculate about the potential market-setting impact the 40-cents-on-the-dollar sale will have on the balance sheets of other builders.

In the same way Lennar's sell-at-any-cost, price-slashing home sales strategy a year ago forced other builders to follow suit, the low sales price in the Lennar-Morgan Stanley deal has the potential to devalue lots in other builders' inventories.

Nick Tramontana of PNT Capital Advisors hopes that the sale will give home builders a reality check on what their land is really worth, adding that many troubled builders have been unwilling to consider the offers for their land because they refuse to acknowledge just how far prices have fallen.

"When you are a private home builder or developer who bought land at the peak, the idea that \$3 million is gone and, worse, you might be underwater, your lender doesn't know it, and you might have a personal recourse on your loan, ... you are not going to want to do anything about it," Tramontana notes. "We hope this can break the dam. I'm hoping it's an empirical data point that we can point to and say, 'This is happening now.'"

While 40 cents on the dollar isn't a magical number that can be applied to all land values everywhere, "What it tells you is that sellers of land are starting to acquiesce, look in the mirror, and face reality," Tramontana says.

And if they haven't started, their bankers certainly have. Regardless of status, be it public or private, the name of the game is making nice with lenders. "Lennar has divested itself of individual pieces in our market at pennies on the dollar," says Eric Wittenberg, CEO of McStain Neighborhoods. "They are not alone; everybody is adjusting assets. The guys who are working nights are the appraisers today."

Wittenberg, a former banker, says the federal government is forcing banks to get tougher on builders, which could compound the problem if lenders start running scared. "The biggest effect is our ability to get financing and the bankers' perception of what the values are," he says.

McStain has had fewer problems because its land holdings tend to be closer to metro areas and in infill locations, which seem to be holding their value better than parcels in outlying areas. But owners of more remote parcels may face having to re-margin their loans by infusing more personal cash in the deal, thereby adjusting the debt-to-equity ratio. Builders who don't have that kind of cash will face having to pay back loans at a faster pace, with banks garnishing a larger share—or even all—of the builders' revenues.

"Large banks are very much aware of the problems with their loans," says industry consultant John Burns. "Some of my smaller bank friends, however, tell me that senior bank management is not dealing with the problem swiftly. That will come back to haunt them. I believe we will see tremendous land buying opportunities from the banks."

"The secret is to convince [banks] that you will do a better job of managing the assets than they would," says Wittenberg. "I think there could be a world of hurt on some private builders who don't have very sophisticated banking relationships. This is one of those times where you keep your friends close and your banker closer."

Loss Leader

Lennar's claw-back tax benefit deal sets an "impairment monetization" precedent for others to follow.

One of the English language's all-time best come-on lines—"It was the best of times, it was the worst of times"—may now take on a whole new meaning at high-volume home building organizations. Never mind Charles Dickens. When the best and worst of times just happen to occur within 24 months of one another in new-home building, a helluva lot of money can be recovered from Uncle Sam in relief on tax bills paid during the boom.

Credit Lennar's tour de force 11,000-lot land transaction as the groundbreaker among home builders on several levels, not the least of which may now earn the ineloquent tag of an "impairment monetization strategy," or "tax claw-back." Under "C Corporation" tax rules, operational losses get a 24-month carry-back period (and a 20-year carry-forward period). Applying these rules to retrieve tax money against impaired land assets may become a common tactic among builders over the next 12 months.

Thanks to its deal with Morgan Stanley Real Estate to sell 11,000 lots at 40 percent of their \$1.3 billion stated value, Lennar can claim losses of \$775 million and obtain a refund against taxes paid in its most successful year ever, 2005.

Lennar's market-changing land plays achieve home building's version of high drama on several levels. First, it's a competitive coup—being the first to strike in a home builder environment broadly glutted with inventory, hitherto regarded as "a no-bid market"—of negotiating a win-win sale of thousands of lots in its currently unloved home site pipeline. Lennar's complex financial feat involves the creation of a "for-tax-purposes" joint venture with

Morgan Stanley that takes the suffocating weight of the land off its books and leaves several important advantages of that same land—including the ability to carry this year's loss in land value back 24 months, and thereby get a check from Uncle Sam for upwards of \$270 million—right there with Lennar.

The JV entity created, to be kosher from an accounting rules standpoint, requires that Lennar have less than 50 percent equity and less than 50 percent profitability participation. From a tax perspective, the Lennar-Morgan Stanley deal stands as a sale of assets for 40 cents on the

dollar. From a "book" perspective, the transaction works more along the lines of a financing deal, which allows Lennar future profit participation, right of first refusal at market rates, etc.

When one adds the tax-back benefit to the upside of Lennar's participation in the JV, suddenly the discount against value shifts from 60 percent to more like 40 percent.

Other home builders—Centex, D.R. Horton, and KB Home to name a few—are said to be trying mightily to effect such deals before their own fiscal yearends.

"Everyone is trying to get these deals done before the end of their current fiscal, since the carry back goes back to the single most successful year in home building ever, 2005," says Steven Friedman, a partner at Ernst & Young LLP. "But if they don't pull it off—and it's not as if it's easy to do, given the due diligence a buyer needs to go through to sign off on the deal—they'll keep trying to do it next year, because the second single most successful year in home building was 2006, and the tax benefit will still be there."

Uncle Sam may be writing some pretty big checks to builders in the next year or so, which is one way to make the best of the worst of times.

—John McManus

Swift and Sure

When it comes to land strategy, be it positive or controversial, Lennar has a history of taking trendsetting and decisive action.

May 2000

Acquires U.S. Home out of bankruptcy

January 2004

Acquires Newhall Land and Farming Co.

February 2005

Acquires El Toro Marine Corps land in Internet auction

November 2006

First to take major impairment

January 2007

Sacrifices profitability for volume

January 2007

Restructures LandSource JV

November 2007

Generates cash via Morgan Stanley JV