The Value of Dirt

Today's land investment market

» JEFF GUNDERSON

An argument can be made that the value of dirt on a vacant parcel is worth more on a relative basis as compared to that same parcel with a completed structure. Once a building is placed on that land, the parcel loses the creative potential to a prospective new buyer. For this reason and many others, raw land is often considered a good investment. But even though land prices have been dropping with the fall in real estate values, is now the time to buy? If there is value to be found at this stage of the market, where should investors look and how will credit challenges affect financing?

According to Geoffrey Koprowski, investment property finance specialist with Portland, Ore.-based Pacific NW Capital, the market for raw land is very good for investors with access to capital and the ability to ride out a long-term hold. "Land speculators need to realize just how much opportunity is available in the marketplace right now for vacant land," says Koprowski. "There are great deals to be found. We have a saying in our firm that is very appropriate to circumstances right now: When markets have inefficiencies it creates incredible opportunities."

Bob Spence, general manager of Huntsville, Ala.-based Love Development, agrees that it is a good time to buy raw land at this stage of the market, but only for investors who are prepared to pay all cash. "Even if there was financing, the terms would be horrendous," says Spence. "Wall Street is still in a big mess, and there is more risk associated with lending on land." Spence says prospective buyers should also be prepared to hold for at least 18 months, because with no financing available the opportunity to sell will be very limited.

"From a lending perspective, raw land is still a very risky proposition," says Koprowski. "Financers are staying away from raw land deals. I'm currently working on one land deal, and it has the lowest probability of closing out of my pipeline of 33 active deals. In this environment, if a bank initiates a foreclosure and repossesses a vacant parcel, they will be stuck holding it on their books. There is simply no market for resale."

It was a very different story only two years ago. Banks were lending on raw land at 65 to 75 percent loan to value. In Portland, speculators and developers were actively seeking out property near the city's urban growth boundary in anticipation of that boundary expanding. "Huge financial gains were realized using this strategy," says Koprowski. "I know one developer who made 470 percent on his money from buying a piece of land, subdividing, and then subsequently selling off the parcels after they were included inside the boundary."

Obviously, that strategy is not as viable as it once was, but Koprowski says there are distinct advantages to raw land in a down market compared to holding real estate. "For one, the carrying costs of raw land are miniscule compared to those of land with a finished structure. With real estate, there is higher utility, maintenance, insurance, taxes and mortgage costs," says Koprowski.

And while land values have dropped, they have not dropped as substantially as real estate prices. "Land values have always been understated. In a boom market, land does not become as inflated as the finished product price," says Koprowski. "But it also tends to hold its value relative to real estate in a down market."

LAND VALUE CONSIDERATIONS

According to Scot Oldham, vice president of Irvine, Calif.-based Developers Research, when deciding whether to buy a piece of land, investors should always consider what the endgame is. "If that plan includes building a home and selling it, then the

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investor should factor in every cost associated with developing and building," says Oldham. "In California, one of the main overriding considerations has become impact fees. If they add up to 20 to 25 percent of the anticipated gross revenues from the future home sale, then the investor is looking at a zero or negative raw land value. In that case, it is not an economically viable purchase."

While impact fees increased in several U.S. states as real estate prices became inflated, California claims the highest impacts fees in the nation as measured by a percentage of the sales price. "Impact fees doubled and even tripled as home values went up; however, they did not come down when real estate prices fell," says Oldham. "Land investing depends on location and each individual piece of property, but in California, until we see an increase in home sales prices or a reduction in impact fees, there will be limited to no profitability on most land purchases."

Bargains on land purchases could be around the corner, but Oldham says that is ultimately dependent on the banks, as they are owners of the majority of the distressed assets. "In many cases, the banks don't even know the true value of their repossessed lots," says Oldham. "The comps are all based on foreclosures, and the bid-ask spread on vacant parcels is still very high. Many banks are still holding on to their distressed assets and are reluctant to write down their properties because they don't want to sell into a bad market. They haven't been forced to clear their books yet, but there is a fear across their portfolio that heavy write-downs could turn them insolvent."

REGIONS

For land speculators with access to capital, what regions and markets hold the most potential?

"The baby boomers like areas where it is warm," says Dennis Smith, president of Homebuilders Research in Las Vegas. "Places like the Gulf Coast, Nevada, Arizona, New Mexico, and Florida should continue to attract a significant amount of retirees." Smith says speculators with financing and the ability to hold for a minimum of two to three years should also consider markets where supply is limited or where the price of land has been reduced to historic lows. "The value of land in Florida and Nevada looks to be as low as it has been in many years," says Smith. "However, Florida has a huge supply of lots. The same holds true for Phoenix. But in Las Vegas, the supply of vacant land is limited."

While Las Vegas may be the poster child for boom and bust markets, the city is also unique because it is completely surrounded by federally owned land, mostly managed by the Bureau of Land Management—a comparable situation to cities with urban growth boundaries. "The real estate market here is worse today than it was six months ago, but it is also presents fantastic opportunities," says Smith. "You can buy raw land here for 25 cents on the dollar. My only question is what's your definition of a dollar? The comps primarily represent defaulted properties, which makes it difficult to determine value. The demand will stay low as long as credit is not available. That makes it a very difficult market for anybody holding land that wants to sell."

However, Smith believes that Las Vegas has potential to be a viable economy in the future. "It's different from many other markets in that it is an international city," he says. "We just don't know yet what real value is, because we haven't seen the bottom yet. When the supply of defaulted properties abates, then prices should stabilize."

VALUE WITHIN A MARKET

In each individual market, what locations hold the most potential? Is it better to buy in the urban core where city revitalization projects could help boost value, or are the better deals to be found near the fringes of the city limits?

Generally speaking, across most markets Bob Spence sees more value closer to the city centers. "The days of edge development are behind us. Cities are increasingly adopting policies towards smart growth and limiting urban sprawl. I think these trends are going to only accelerate," he says.

Only three to four years ago, during the previous building boom, buying land in the path of growth was a viable and often lucrative strategy. "In Huntsville, this was a great strategy because subdivision annexation was always guaranteed," says Spence. "However, under the city's new administration, that is no longer the case. Like with many U.S. cities, the City of Huntsville began questioning if it was just growing without a plan. Now, they have become increasingly interested in mixed-use projects that incorporate density and utilize existing infrastructure."

Of course, investing in a market by following this trend should ultimately depend on the governing entity's view on redevelopment and urban infill. But for those cities that are on board with this philosophy, there could be potential for buying in the vicinity of future transit-oriented development or in areas spurred by city revitalization projects.

"There could also be opportunities for buying industrial-zoned land that is located in areas of the city where rezoning it to residential and building high-density townhouses would make sense," says Spence. "I see more of these types of economically viable opportunities in the future."