Residential Futures

THOUGHT-PROVOKING IDEAS ON WHAT’S NEXT FOR MASTER-PLANNED COMMUNITIES
About the Urban Land Institute

The mission of the Urban Land Institute is to provide leadership in the responsible use of land and in creating and sustaining thriving communities worldwide. ULI is committed to:

- Bringing together leaders from across the fields of real estate and land use policy to exchange best practices and serve community needs;
- Fostering collaboration within and beyond ULI’s membership through mentoring, dialogue, and problem solving;
- Exploring issues of urbanization, conservation, regeneration, land use, capital formation, and sustainable development;
- Advancing land use policies and design practices that respect the uniqueness of both built and natural environments;
- Sharing knowledge through education, applied research, publishing, and electronic media; and
- Sustaining a diverse global network of local practice and advisory efforts that address current and future challenges.

Established in 1936, the Institute today has nearly 30,000 members worldwide, representing the entire spectrum of the land use and development disciplines. ULI relies heavily on the experience of its members. It is through member involvement and information resources that ULI has been able to set standards of excellence in development practice. The Institute has long been recognized as one of the world’s most respected and widely quoted sources of objective information on urban planning, growth, and development.
About the ULI Terwilliger Center for Housing

The mission of the ULI Terwilliger Center for Housing is to expand housing opportunity by leveraging the private sector and other partners to create and sustain mixed-income, mixed-use urban and suburban neighborhoods that incorporate a full spectrum of housing choices, including workforce housing, compact design, and connections to jobs, transit, services, and education. The Center achieves its mission through a multifaceted program of work that includes conducting research, publishing, convening thought leaders on housing issues, and recognizing best practices that support the mission of the Center.

Established in 2007 by J. Ronald Terwilliger, former chairman of Trammell Crow Residential, the Center’s original mission was to expand the availability of workforce housing opportunities for families earning 60 to 120 percent of the area median income.

Although the Center’s primary focus remains on housing affordability, with a particular emphasis on workforce housing, the expanded mission now includes a broader range of housing issues. This expanded focus will integrate ULI’s many housing efforts into a coherent program of work that furthers the development of mixed-income, mixed-use communities and a full spectrum of housing affordable to all, a critical aspect of ULI’s core mission of the “responsible use of land.”

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Introduction

At the May 2012 ULI Spring Meeting in Charlotte, North Carolina, almost 200 ULI members crowded into a standing-room-only panel discussion on a topic that is of great interest to many in the real estate community: the future of residential development. During the session, titled Making Money in Residential Real Estate: What Will the Housing Business Look Like in the Future and How Will It Be Funded?, participants explored the role that market and site selection; community, neighborhood, and home design; marketing and communications; and debt and equity will play in the new housing and community development model.

In conjunction with that session, panel member and ULI trustee Robert Sharpe, president of Sharpe & Associates and the developer of Rancho Sahuarita, distributed a 17-question survey to further engage industry leaders in the ULI network who specialize in master-planned community (MPC) and residential development. This discussion paper, produced by the ULI Terwilliger Center for Housing, captures their thoughtful comments and thought-provoking ideas on what’s next for MPCs and offers some possible insights on the future of residential development in general. To be clear, this discussion paper should not be considered as an analysis of the market by ULI or a prediction by ULI of what will happen.

The discussion paper is organized into four chapters. In the first chapter, real estate industry leaders from across the country weigh in on who will be buying new homes, what amenities consumers will expect to see in their communities, and reasons why consumers will elect to purchase new homes over resales. Chapter 2 highlights their best thinking on where to develop, what they see as the future of suburban development, what design and amenities will attract buyers, and what breakthrough ideas will make development successful in the future. In the third chapter, respondents are asked how their marketing strategies will change as a result of emerging digital technologies. Finally, in chapter 4, top industry leaders discuss the status of the capital markets, the new paradigm in profitability for homebuilding, the future of infrastructure funding, and the new business model for residential development.

The purpose of this publication is to share a wide range of ideas suggested by ULI members engaged in residential development and to stimulate further discussion on the future of MPC development in general. Although the insights shared here may, or
may not, be useful to other real estate, this discussion paper is not directly focused on other for-sale housing beyond MPCs. Importantly, the rental market and apartments are not covered. We hope this report will prove beneficial to members and other partners in the ULI network and will further the goal of helping create better and more sustainable places to live.

Methodology

In conjunction with a session at ULI Spring Meeting 2012, ULI trustee Robert Sharpe distributed a questionnaire to engage real estate industry leaders on five topic areas originally identified by the session’s moderator, Gadi Kaufmann, managing director and CEO of RCLCO. The five topic areas were (1) new consumer/demand paradigm, (2) what and where to develop, (3) marketing and communications, (4) capital markets, and (5) exit question. The five topic areas resulted in a total of 17 questions. For the purpose of this report, the fourth and fifth topic areas were combined.

Sharpe e-mailed the questionnaire to 70 ULI members who specialize in MPCs and received 31 responses, which resulted in nearly 50 pages of narrative answers to the questionnaire. The ULI Terwilliger Center for Housing then carefully reviewed all of the responses and selected five or six answers for each question to include in the report. The responses featured in this report were chosen because they represented the diversity of opinions expressed by the respondents.

Each chapter of this publication is accompanied by a word cloud—a visualization of word frequency in a given text as a weighted list. Given that the discussion paper captures only selected responses, the Terwilliger Center used word clouds as a graphic concept to incorporate other key words and phrases from the original questionnaire responses.

The ideas contained in this report are just that—ideas. Because of the nature of the discussion paper, responses to the same question may show a degree of disagreement or be flat out contradictory. The included comments and word clouds represent the opinions of the select group of ULI members contacted with the questionnaire. Each response (identified by a triangular bullet point) reflects a different person’s view. The views expressed in this report are not intended to be representative of the entire ULI membership.
The New Homebuyer

In decades past, developers have produced more than 2 million homes per year, a supply far in excess of demand. After the housing bubble burst in 2008, many communities were hit hard by foreclosures, creating widespread homeownership losses. As the economy continues to recover, markets are beginning to stabilize, but one thing is certain, the “old” normal will not return, because homebuyer preferences are changing. Expanding cohorts such as intergenerational families, single women living alone, generation Y, and baby boomers are all pursuing different lifestyles that require a range of housing choices and amenities to better suit their needs. Consequently, investors and developers have had to become more sophisticated in meeting housing demand, which varies from market to market, by changing their traditional business models to adapt to the preferences of today’s consumer.

Who are the customers that will be buying new homes from 2012 to 2015?

- **First-time buyers**, who are streaming out of apartments, their parents’ homes, or overoccupied dwellings, will continue to form new households. Comprising primarily younger couples who already have children or who are planning to get married and have children, these first-time buyers will be 30 percent of the market.

- **Young women in their 20s are outearning their male counterparts** and buying houses at twice the rate of their male cohorts. In addition, baby boomers, who are facing retirement, are moving to smaller homes, located closer to their children, and to retirement communities or buying vacation homes.

- **The first wave of buyers will be renters and young families** that have been doubling up or staying with parents. They will be less fastidious than buyers in 2005 because their new home purchase in 2012–2015 will be a substantial upgrade from their
existing living arrangement. These buyers will be very price sensitive from a monthly payment perspective. As these buyers absorb inventory, prices will firm up, allowing the move-up segment to sell their existing home and upgrade to a more appropriately sized home for their circumstances. Most buyers during this time frame will be incentivized by need rather than want.

Nationally, the move-up market has accumulated five years of pent-up demand that has been frozen in place for a variety of reasons, including a lack of homebuyer confidence and urgency and a lack of mobility, resulting from “underwater” mortgages, slow job growth, tighter mortgage underwriting guidelines, and a continual stream of distressed home sales. When those buyers are able and ready to sell their existing homes, they will trade up.

Many 2012–2013 buyers will be people who decide the market has bottomed out and want to seize a bargain while they can. By 2015, more vibrant job growth and appreciating home values will prompt buyers, who have rented for several years or who have burned off the five- to seven-year credit impact of a foreclosure or short sale, to return to the owner-occupied housing market.

At best, we’re in a transition period as we emerge from a devastating economic collapse that has crippled most consumers, particularly the baby boomers. The most important question is: How quickly will the impending recovery take hold and consumer confidence rebound? No one knows the answer for sure, but given the present headwinds, renewed demand from all demographic sectors is dependent upon improving conditions. In the meantime, the residential development industry will continue to be forced to cope with limited pockets of viable demand from each of the age groups.

The forecast appears to be favorable. From the standpoint of pure fundamentals, supply/demand conditions, and the historical cyclical nature of the U.S. economy, we could be on the verge of a surprisingly strong economic and housing rebound. Although significant headwinds remain, many of these complications could prove illusory and quickly dissipate. For example, improving economic conditions and the perception that the economy is truly recovering could cause the all-important consumer confidence factor to explode. Repercussions from this shift from “fear” to “greed” could escalate.

Last, a full-blown economic boom is not needed to unleash these factors; often what is needed is to reach the tipping point from the consumers’ perception that conditions are finally improving.

So, as this downward trend of the last six years reverses course, we are positioned to benefit from an upward cycle supported by demand that will be fairly evenly spread among the three generational groups, all of which will quickly gain traction over the next several years. For example, gen-Yers, though young and income constrained, will move into the homebuying phase (and out of the rental phase) and will be a strong consumer of new starter
homes and resale, baby boomer homes; generation X, though smaller in numbers, arguably is the most stable economically and socially and will be buyers of new, move-up housing and resale boomer houses; and the baby boomers, upon being able to sell their existing houses to gen-Xers and Yers, could become the 800-pound gorilla again as they reenter the market for downsized houses, retirement homes, and second homes.

What does the buyer need in terms of housing and community?

- **Buyers want safety, good schools, and proximity to employment,** which usually entails less than a 30-minute commute. Financial security related to the home purchase means that the community is on stable ground and the builder is viable. Buyers want to feel that the housing value is permanent and appreciation is likely over time. They want amenities that fit their lifestyle and that they can afford.

- **Although widespread, sweeping changes are unlikely, some shifts will occur.** Certainly golf courses have continued to slide as a required amenity, confirming a 30-year trend and the family market’s historical low ranking of golf as a recreational preference. Favorable trends include less wasteful floor plans and square footage, better design of outdoor living areas, first-floor and/or double master bedrooms, multigenerational housing designs, and community gathering areas, including passive open spaces.

- **The market is too niched to answer the question definitively;** the developer has to understand every community and appeal to its unique buying group(s). Each niche will have different needs.

- **These buyer groups are looking for value (affordability), walkability, shopping, restaurants, services, good schools, and a sense of community.** They are weighing all the tradeoffs that go into the home purchase decision, including what is offered in the home and community compared to what they really need. Lessons from this recession will linger, and this conservative attitude will factor into the homebuying equation. Developers will have to prioritize and focus on what’s important to the buyers and what they value, which means giving up something else—that’s why it’s even more important to be in tune with what your buyers want.

- **Buyers require a situation where they have certainty about “additional costs.”** They are willing to accept less in terms of community and community amenities in exchange for fixed costs. They need good transportation (mass transit will be more and more of a plus), walkability, and good public schools. Convenience and time savings are huge to the young family or new buyers. Proximity to health care is also important.

- **Single-use zoning is out and mixed use is in, along with living close to services and jobs.** The typical MPC offering, including schools, parks, and pools, is still important, especially to first-time buyers. Couple that with a scarcity of resources, living near where you work and shop is in, long commutes are out, and the old outer-ring suburbs, with big commutes to shopping and jobs, will start to lose market share to locations that meet the changing needs of the market. Energy efficiency is going to become more and more important.
In terms of what buyers need, what they need is what they can afford and what they can get financed. With so many houses underwater and with many of those who need housing having impaired credit, the bulk of buyers may not be able to be choosy about what will satisfy their housing needs. Although “green” and “energy-efficient” housing products attract customers to the models, to date, most customers are not willing or able to pay much extra for such admirable features.

As to buyer preferences about the community, many of our planned communities really are not that great or that different from the nonplanned communities, and most are burdened by extra improvement district taxes, assessments, and homeowners association fees. Bigger is again better or more salable in regard to lot size, and renewed demand exists for traditional-sized lots (4,000 to 6,000 square feet) because land values are so low. As land values escalate, affordability issues will again change the demand toward higher-density detached products, with the exception that significant construction-defect litigation is still occurring, which will mitigate any increase in attached for-sale product.

Why will the consumer buy? Will it be new or resale?

- **New homebuilders have an opportunity to remove (rather than increase) the fear factor of a home purchase in today’s environment.** The most important factor in driving a new home purchase will be education. Buyers in all price points are concerned about “losing everything.” Reducing this fear of the unknown is uniquely available to the new homebuilder.

- **People have always had many reasons to buy a new home as opposed to a resale.** The house is brand new. Those trying to purchase foreclosed houses or short sales from lenders can suffer from frustration and time delays. Buyers have some concern about investing in a resale home in a distressed neighborhood where the home is surrounded by rentals and houses in some degree of default (although this same environment may also exist in partially completed MPCs). In a new-home community, buyers have some sense of security in knowing that most of their neighbors will be homeowners just like them.

An interesting result of the years of bad times for homebuilders is that many do a really lousy job of merchandising and marketing their new homes; as a result, they are not really exciting the customers. As the market improves, the smart homebuilders will again have something new, different, and appealing to offer. Only recently are we seeing the new energy-efficient houses or next-gen houses coming to our market so that there is truly something different and hopefully better. Appraisals continue to be a problem for the builders of new homes, but this situation should gradually improve.
The resale housing stock continues to age in place. The further we move in time from the boom years, the older the resale inventory becomes and the easier it is for new homes to compete with existing homes. In 2009, a 2006 home was almost new. After six years, the new and innovative products, with a lower ownership cost in regard to utilities and maintenance, plus a builder warranty and easier mortgage underwriting, provide a distinct advantage.

Cost savings: eventually people will come to recognize the operating cost impact of owning a home, similar to the operating costs of cars with low versus high miles per gallon. But generally all of the reasons that people typically buy new versus resale remain true, including that they have none of the repair hassles associated with old homes, the opportunity to self-select into neighborhoods with others in similar situations (young families, for example, or active adults of approximately the same age), and the fun of building a new home just the way you want it. The 20 percent of the market that prefers new will continue to purchase new for many of the same reasons; however, for builders and developers to attract the other 60 percent (assuming 20 percent are avid resale buyers), they will have to innovate and provide something new to the market. The same rehashed home designs for 2000–2006 will not work. And location, location, location will be increasingly more important.

Two scenarios affect two types of buyers. Those who were foreclosed on may want to buy, but they have low FICO scores. They may also have a large amount of cash if they stayed in their home until the actual foreclosure (since they were living for free) rather than short-selling and trying to lessen the impact to their credit rating. This demand may be on the sidelines until their credit improves, but they will have a better chance at making a downpayment if the 20 percent QRM (quality residential mortgage) holds firm.

The other demand is from the homeowner whose home is underwater. They need market improvement or solutions brought about by the government to purchase a home, whether it is new or resale.

Several years will have to pass before both of these buyers will revert to normal demand trends, and when they do, they will buy closer in as opposed to at the city edge. The new-home market will not again approach the historic 30 percent comparable to resale numbers for many years.

Note
Where and What to Develop

The recent economic downturn has dramatically altered the way of life for many in America. Consumer decisions about where to live, whether to rent or own, and how to select a desired home style and amenities are challenging old conventions and changing the landscape of urban development. Just as consumers are considering new and different lifestyle options, community leaders and developers are looking for more efficiency and productivity. These choices, whether made by desire or necessity, have led to the refinement—and in some communities, the dissolution—of traditional Euclidean zoning (common in the post–World War II era), in favor of what is thought of as more sustainable development patterns that can support mixed uses and diverse housing types. But many questions remain: how deep is the market for this evolving type of development; how will residential developers meet these diverse demands; where will they develop, and what will the end product be?

In terms of market and site selection, what factors will help developers make the right choices?

- Historically, in difficult environments, price elasticity, as correlated to the quality of location, standard lot configurations, and manageable capital outlays, becomes the primary force and will dissipate in importance as markets heat up.

- “A” and “B” submarkets will be in demand for only the near term. When “A” and “B” submarkets become too pricey or supply constrained, then “C” submarkets will come into the equation. “D” and “F” submarkets will stay speculative areas. The key word that needs to be remembered when choosing development sites is proximity—proximity to jobs, proximity to entertainment, proximity to good schools, proximity to something. During the next up cycle, the tract house subdivision, located in the middle of nowhere, will be a very bad bet. If (or really when)
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gasoline prices start to rise, a major trend will be putting new rooftops next to existing employment (and services) and moving employment (and services) closer to existing rooftops.

In general, job creation and new household formation need to be proximate to justify development. There simply won’t be enough demand to support development if job creation and new household formation are not happening relatively close to the candidate sites.

It takes a much more holistic picture of the market location than ever before. Typical real estate feasibility research is 80 percent rear-view mirror and 20 percent present day. Understanding all of the other factors that result in a good business decision is vital; such factors include local job growth, school performance, area anchor institutions, leadership, and the local appetite for growth and development. And then discovering the underserved segments of the markets is important.

The key to success is still location, location, and location. Invest in “A” and “B” markets and submarkets that have good long-term housing demand and diversified economies that will create job growth and demand. The real challenge will be to have the ability to fund big enough communities to support required overhead, infrastructure, and amenity costs.

It’s really “back to the future.” It’s not new; it’s literally going back to the basics that existed prior to the runaway market conditions when anything would sell. The key is to be innovative, understand your market, and make development decisions totally driven by what motivates your customers to buy and what they can afford. No matter whether the need for shelter or investment, income motivates the future buyer. It will also make sense to focus on where the jobs are, where customers want to live, where the schools and amenities are best, and what can be affordably developed. The basics of residential development haven’t changed.

Is suburban development dead? How does urban and infill development work for large homebuilders and community developers?

Suburban greenfield development is not dead, just dormant until infill prices increase and push people out. Infill concepts seem at least partially compatible with what large builders do so long as that is where margin can be found at the possible exclusion of other locations. For traditional community developers, however, a retooling of skill sets and a new business model may be required to approach life a little differently.

Big builders are still suburban; they are not making much on base buildings, but they are making money on upgrades. It is all about sales pace, too.

Extreme suburban is dead, but good infill suburban will do well. Urban is tough for builders because the only way to get the scale they need is to go vertical, and vertical (condominium) development financing is nonexistent. That being said, several homebuilders are talking about building apartment projects in urban settings.
It is probably dead until generations X and Y start having families. Lots of entitled land needs to be absorbed or reworked. Immigrants are the wild card. Hopefully, they will still aspire to the American dream of owning a home, and they will probably support the more traditional forms of development. Conversely, urban, hip, and mixed use will stay hot. Large homebuilders and community developers need to retool—they need to think smaller and more complex and to provide customers a lot more care and feeding than the high-velocity-experience set is used to.

Suburban development is not dead but needs to take cues from the things that make urban development attractive, such as creating walkable environments that offer lifestyle alternatives. Mixed-use development ideally includes employment (or at least, not too far away) but at a minimum offers a high-quality lifestyle and retail alternatives. Also, urban infill buyers tend to be similar to “early adopters” of technology. They’ll pay more and deal with frustrations to get the psychic benefit of their lifestyle choice. Eventually mainstream buyers tend to follow these early adopters, but only at lower costs and not as extreme. So, for example, sustainability and efficiency are important to infill buyers, and these concerns will increasingly become part of the equation for mainstream buyers as well.

Exurban is not dead, but only a handful of communities will succeed if properly geared to employment centers. Close-in suburban, with mixed-use and mixed-income communities, will do well in the long run. Large homebuilders and community developers have to diversify into the nonresidential and residential mix.

The feasibility of suburban development is always questioned in a struggling economy, but people keep moving to the suburbs. They like their yards, good schools, and secure way of life. Urban infill is not a scalable business model for most production builders, so the suburbs will be the areas of choice for builders and developers again within the next few years, if not sooner. Suburban isn’t dead, but it is certainly declining in its absolute dominance of the housing market. Remote suburbs located at the edge of major metros are losing market share to housing options located closer to town as a result of better proximity to jobs and services.

What will make good community, neighborhood, and home design? What are the amenities?

Well-designed smaller homes will prove to be more successful. Amenity packages in the future should be well thought out to be sure the maintenance costs are relatively inexpensive. Stay away from golf courses.

Homes should be designed to appeal to an increasingly technological homeowner. Home offices and energy-efficient appointments will become requirements of new homebuyers. New housing concepts will be sleeker, more compact, and ingeniously designed so spaces can be transformed for different kinds of use throughout the day. Manufactured housing and conventional homebuilding could even converge to produce more sophisticated products in a modularized delivery system.
Residential Futures
THOUGHT-PROVOKING IDEAS ON WHAT’S NEXT FOR MASTER-PLANNED COMMUNITIES

- **It is more refinement of what we already know.** People love community pools, because they don’t have to pay the cost to build and take care of them. People love trails and open space. People think golf courses are the same as open space (painful to say) and so golf is dead.

- **Back to basics, consumers do not want to pay for amenities that they simply drive by and don’t use.** The hard part is to figure out what consumers are going to use before you build the amenity. Sometimes, consumers don’t know what they want until they see it.

- **Social networking and technology.** Who needs a computer room if everyone gets an iPad with their new home!

- **Lifestyle amenities will not change dramatically, but rather they will evolve.** The same with homes. And it is not “green” that will draw the customer, but design innovations.

Great planning is definitely important, but the really important part is how you establish a framework for ongoing social infrastructure and how that can transition into “the community and its residents.” The social side is what really makes for a good community. Obviously, having appropriate, attractive, and cost-effective spaces in which to have “social interactions” is important, but even the best plans cannot make the people become tighter and feel good about where they live (and recommend the community to their friends and family).

**What are the new development ideas that will be successful in the future? What are the breakthroughs?**

- **Lessons of integrated marketing and segmentation will be brought to the urban core.** Taking a portfolio of products, woven through an existing inner ring and urban fabric will be sold as a unique opportunity—leveraging the best of old character with new kitchens and homes.

- **Reverse the parasitic relationship between retail and residential,** where in the past we had to first put up the rooftops before retail would come along and feed off us. Given the strong desire to provide residents with walkable retail (via our building pre-mature, economically unviable Village Centers), developers should explore buying and developing parcels adjacent to some existing small-scale or strip centers and attempt to “retrofit” these structures as our walkable retail amenity.

- **One of the biggest challenges for the industry is the love-hate relationship between municipalities and developers or builders.** The old attitude that, “well, maybe I can fly under the radar,” still exists, and leaders at the local government level can be behind the times in terms of planning and building concepts. The one thing that could lead to better communities is to enhance communication between these two groups and engage in meaningful dialogue about what is best for our communities and how to create better places to live.

- **Capital providers and buyers are demanding more micro planning.** Development will be in smaller neighborhoods, and segmenting will be more refined, even to the street level.
One major breakthrough pertains to the high level of transparency that is expected by the consumer today. Embrace diversity within community. Really implement more energy-efficient and green approaches (not just greenwash fluff).

Home features, including legacy designs, energy efficiency, and wrap-around courtyards, are the current “new” ideas that are working. Average home size remains in the 2,100- to 2,300-square-foot range. Future? If the amenity provides value, saves time, and somehow makes life better or easier for residents, it will be popular.

The greatest breakthroughs will not be expensive additions to design. They will be inexpensive shifts that affect the way we live our lives; for example, mini-MPCs will be executed on 50- or 100-acre sites in the first or second ring of major metropolitan areas around the country. Sites will be 40-year-old strip malls, car dealerships, old light-industrial areas, and other locations that are close to where it is happening. Again, the key to good site selection will be nearby proximity to something. We will learn to work at 20–40 dwelling units per acre and to build more compact amenities. The art of it will be to create higher-density environments that feel relaxed, comfortable, and open. We will readily mix in active adult/age-targeted homes with conventional homes in nearby neighborhoods. There won’t be any explosive breakthroughs, just continual refinement.
Chapter 3

Marketing and Communications

In the mid-1990s, a new technology opened up a world of possibilities: easy access to information, high-speed communication, and the convenience of shopping within the comfort of our own home. But one of the biggest changes brought on by the Internet was the transition from individuals as just consumers of information to individuals as producers of information, enabling users to generate a “buzz” about products. This new development created a dramatic shift on a proven marketing strategy, vastly improving “testimonial” types of endorsements because the publicity generated was more transparent, sincere, and usually not promoter instigated.

Emerging digital technologies enabled new business opportunities and accelerated a new generation of marketing. Social media platforms, such as Twitter, LinkedIn, Facebook, and YouTube, combine technology and social interaction, giving marketers a voice and allowing them to communicate with customers and potential consumers by using an efficient, low-cost method. During these challenging economic times, residential developers are implementing online marketing and social media campaigns, not only as cost-saving tools but also to gather detailed consumer information, to personalize branding messages, and to allow users access to information on demand.

How do you market and communicate differently with today’s consumer?

▷ The message must be different. Much like investors, buyers will be interested in downside protection. Unfortunately, the psyche of buyers has changed to include the “investment” aspects of homeownership. Financial and physical security for their families have merged to become important criteria for homebuyers.
It’s all about digital marketing, with the role of traditional print and electronic media being used solely to drive people to the digital media. Expect to see housing subjected to the same kind of “user review” scrutiny that consumer products currently receive on the Internet. The goal will be to produce and sustain happy residents who say great things about the community online. Honest referrals will be more important than ever!

We are paying a lot of attention to social media and trying to understand how the younger buyers (and renters) shop and make purchasing decisions. We expect that we will be spending considerably less of our resources in print media and devoting much more effort to positioning our projects on search sites and to tailoring our marketing to our various target customer groups and even individuals. We are now working on accepting online payments from tenants, processing work orders online, and accepting digital signatures on leases. Beyond that, we are trying to be good observers of what is working for others, even in other industries, and we are listening more to our younger employees who are more typical of our customers.

Our new communities will have a far greater web presence, including Facebook and other social media platforms, than older communities, although the older communities now have those assets as well. But new communities will be digital. We will use far less print media or newspaper ads.

In general, the old paradigm was to withhold information to force buyers to have to visit your site; the new paradigm is to provide as much information as possible so they will select your site as one to visit. But you also need to remember that this stage of the marketing process is just to get buyers to your site. Once they are there, you need to have a professional presentation that communicates your competitive advantages and creates enthusiasm for your neighborhood.

Begin with better customer insights: customers first, then product. Then, develop customer-centric relationships at the individual level. For example, we communicate with buyers at the individual level, then we tailor the information based on what customers have told us, including through e-mail campaigns and social media.

It’s time for the MPC industry to follow the lead of big consumer companies. We guess on our messaging right now—it’s not a science; it’s an art. Marketing needs to be a combination of science and art. The big companies of the world use psychogenic market segmentation and analysis studies to target their buyers and identify messaging cues that resonate. It will give us a competitive advantage.

Marketing is still about finding out what is at the core of what buyers seek and at the core of their feelings and desires. Going forward, we can use the full scope of tools in each aspect of the marketing mix and truly focus on the details. Furthermore, for MPCs, marketing has evolved to convey a sense of community and connect to residents and buyers.

Today, a great trend exists toward, and hype is associated with, using social media to sell homes and community. MPCs have an opportunity to embrace social media, not as another tool to sell, but as an avenue to better under-
stand the wants, needs, and desires of the consumer. It’s an opportunity to connect. It is absolutely paramount to this changing market not only that MPCs understand consumers and listen to them, but also that consumers feel engaged and appreciated as a participant with the right message, in the right format, at the right time.

The demographic is shifting toward accepting more of a blended model of communication but is still engaging and interested in the power of face-to-face conversations and connections. Social media, by itself, is not a tool to sell a community, but is rather a tool to engage a community and drive a lifestyle.

How do you change your marketing strategy to persuade consumers to purchase a new home over a resale in the 2012–2020 market?

- **A well-trained sales force is key.** Buyers are not buying as an investment any more. We need to understand their wants and needs more than ever before. Psychographic training may be the key.

- **Just sell and market new homes as energy efficient** and include better products in them, such as windows, water conservation, and the like, to attract the 65 percent of buyers who want these qualities.

- **The practical approach of presenting your project with a high level of “fit and finish” still works.** Refreshing and repositioning your models that have likely aged is a good start. Much of the resale market will have continued to age, resulting in higher maintenance costs and their accompanying frustration. Much of the resale market will have been turned into rentals and could be considered damaged goods.

- **For most buyers, competition from the resale market will always be there.** New-home pricing power will be constrained until the valuations in resales climb back to within closer parity to new, which is usually 10 to 15 percent less. We will slowly work through this situation, and in about two years, it will be much less of an issue. In the meantime, builders are going to get squeezed, because they will definitely experience escalating construction and land costs, among other pressures, because of competition for scarce resources from too many builders.

- **Understand who your buyers are, design homes to meet their unique needs, create a relationship, and then continue to talk with them.** The majority of homebuilders and developers do not understand who they are selling to and do not spend sufficient resources to understand their market[s] in nuanced ways that could make a real difference to the bottom line.

- **You have to be careful with bending too far to what “customers want.”** Remember what Steve Jobs said? “It’s my job to know what the customer wants because they don’t actually know what they want.” To develop sustainable MPCs, I think you have to be bold and hold strong against the winds of wants from customers that damage community value (i.e., garage doors facing the street, big lots, and so on).
Another reality is that millions of potential customers are walking around with damaged credit caused by the financial crisis. Real potential for financial innovation exists in our industry, as builders and developers figure out how to partner with lenders to finance or lease-purchase to good customers with damaged credit.

If we don’t understand our customers, we will soon be out of business.

One area of customer knowledge that needs to be studied is the impact of our current recession on the ability and desire of our potential customers to buy a house. The negative experiences of the past and resultant credit problems will discourage or prevent many from buying a home in the near future. Even the circumstances of many recent college graduates, who are burdened with significant student loan debt and limited employment opportunities, will diminish what otherwise would have been a significant pool of homebuyers.

The challenge will be to understand the credit problems of the potential customers; if possible, to assist them in obtaining suitable, if not better, financing for a new versus a used house; and to convince them that investing in a new home in a good quality community is in their best interest for the long run. For community developers, the challenge is to make sure that the living environment and amenities offered are significantly better and more appealing to the homebuyer than those of a resale community.
Chapter 4

Capital Markets

Gone are the days of record-breaking sales and profits for homebuilders and MPC developers. In fact, over the last five years, residential development entrepreneurs have had difficulty making any profit at all. Their biggest challenge is to stay afloat until the real estate market recovers. But there is a light at the end of the tunnel; recent profit trends are on the upswing, and homebuilders are returning to or enhancing their profitability. As the economy shows signs of recovery, homebuilders are proceeding with caution by shifting business models and diversifying their investments to eliminate losses and prepare for the future demand. During these unprecedented economic times, the likes of which have not been seen since the Great Depression, limited financing opportunities have forced residential builders to become even more creative.

What is the new paradigm in profitability for homebuilding? What return on equity will new developments generate for sources of capital?

- The public builders seem to be content at the moment to break even operationally on a global basis. As the market improves, builders will be very protective of margins and work to squeeze residual land values as much as possible in the early stage of the recovery.

- The biggest challenge will be replacing rolling option lot takedowns and creating innovations in funding land development. Builders will have to come to the table with more than a 10 percent deposit because banks and lot financiers will not want to provide low-cost, high-risk equations. There will be multiple stacks of capital for land, and horizontal and vertical improvements, all with varied pricing for the associated risk.

- This question can only be answered within the context of the availability of leverage. The public builders, with access to public debt, will temporarily be at an advantage, compared to the smaller private builders, and can likely achieve gross margins.

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in the mid-to-high teens while maintaining volume. Private builders will achieve those levels of profitability only when leverage becomes available to them. New forms of debt will become accessible within the next three years.

Most recently, many of the public homebuilders have raised their return criteria from a variable contribution (however that is defined) of 18 or 19 percent to numbers in the low to mid 20s. The rationale given is that development is riskier now, although the real motivation could be to squeeze the land sellers to lower their lot costs. Adding to the confusion as to what returns private builders “deserve” is that we are competing with public homebuilders who have the ability to impair assets without seriously hurting their stock prices, or with equity funds who are betting with other people’s money. We are not on a level playing field.

Until sufficient job growth and demand for new housing reappear, the pace of home sales will be tepid, and pricing power will be weak for builders and developers. Margins will remain thin for the next few years as builders that have retooled with smaller contractor and employee bases try to keep those people busy and intact until the market returns to a meaningful level. Real estate continues to be a very local business; we do not have one national market, and we are already seeing some regional markets recover sooner than others.

The short answer is probably faster in and out, but expectations and rates of return appear to be compressing for people who are being realistic. Although the opportunity guys are still looking for 25–30 percent annual returns based on the optimistic models in their spreadsheets, no one, not even their analysts, expects them to achieve those returns.

These days, the biggest issue for nontraditional capital providers is always capital preservation. How do we know that we’ll get our money back first and foremost? Then, what kind of return can you give me? Market uncertainty appears to be transforming the adversarial nature of the builder, developer, and capital relationship to one of collaboration and cooperative alliances, and more creative partnerships are becoming the norm. People have now recognized what they are good at and what they are not good at and that they need each other to be successful and make the entire development process work.

What is the new paradigm in profitability for community development? What return on equity can community developments generate for the capital providers?

Equity for new community development is likely to be scarce for the next few years. Many of the interrupted developments (either just started or partially developed) have changed hands in the past couple of years or are in the process of changing hands. Because of funding constraints, most of the new community developments that will be launched in the future will be smaller than those that were started between 2001 and 2006.
The lack of competition from other developers and the supply limitations on finished lots will drive developer margins over the next three years. Most developer margins will end up being in the 30 percent range over this time frame; however, underwriting to these levels could not be substantiated today.

How to underwrite the likely prospect that a large-scale development will have to survive multiple economic cycles is the primary issue. Although this preference may be heresy, we like land and are uneasy about stocks and bonds; so to some extent, we would be satisfied with a real estate investment that generated an anticipated return of a few percentage points above inflation. However, notwithstanding my emotional attachment to developing MPCs, when I then try to adjust for the risks and skill involved in owning and developing raw land, I still end up thinking the returns need to be in the 20 percent range.

Because generally no debt is available, most equity investors are looking for 20 to 25 percent unlevered returns, which compresses prices and limits trades. Most private equity buyers of projects today are hoping for an eventual increase in demand and lot scarcity to push up values beyond their pro forma. Good projects in good locations can be underwritten in the high teens unlevered, but investors still need to rely on a rapidly returning home sales market to justify higher pricing and the return of debt to recapitalize their investment. The time frame for these investors is often five to seven years, resulting in an emphasis on acquiring smaller projects that can meet this shorter time horizon.

It is doubtful that a paradigm shift has occurred in the returns that are required to attract capital to land development. Expected internal rates of return (IRR) are still clustered around the 20–25 percent range. New community development projects (and subsequent phases of existing MPCs) that require substantial off-site infrastructure expenditures are probably not feasible as long as an inventory of distressed properties is coming onto the market at below reproduction costs. Only when this competitive supply is absorbed and prices escalate will reentering this business once again make economic sense for developers (and therefore lenders and equity partners). During these past few years, builders have been forced to deplete their impaired lot inventory while searching for distressed improved-lot acquisitions (if any remain).

Who has capital (debt and equity) for residential real estate and community development, what are they looking for, and what are the hurdles, terms, and prices?

Public builders have the money for today’s subdivision deals, and private equity is looking for the larger plays. As we bump along the bottom, builders are willing to operate thinly and maintain enough inventory to stay open with a “skeleton crew.” Rightly or wrongly, the private equity guys are beginning to see community development as a high risk.
Private equity will drive and finance community development. Hurdles will be in the 20 percent–plus IRR range, but underwriting will be difficult. The real winners will be those developers that already own land in good locations with primary infrastructure in place.

Banks do not seem ready to lend for development construction. Although hard-money lenders have preferential rates in the 12 to 15 percent range, these sources have maintained consistent lending practices (post peak compared to pre peak). As would be expected, public homebuilding companies are requiring quick returns [i.e., purchase an asset and start recovering their investment within 12 to 18 months]. Developers who have the financial ability to facilitate lot inventory for builders will be the first in line to achieve the highest land prices as the market recovers.

The handful of funds that are playing in that space all want 20-plus IRRs and to be in and out in three to five years. Obviously, at current housing absorption levels, these thresholds will not work for large-scale projects, because most of them have time frames longer than five years.

The good news is that institutional and private equity are available. Debt is still a difficult issue for land acquisition and development, and although not impossible, it almost makes sense to fund with all equity, considering the current scarcity and terms of debt. Debt providers are typically smaller, regional banks, and they are primarily active in areas that are doing well now or have mostly recovered. The bad news is that we have had real problems finding bank debt for good land development projects.

Plenty of equity is looking for deals, but there is a shortage of deals that work based on current underwriting criteria. Equity that bought developed lots is now finding out that it needs to participate in the vertical construction to achieve the returns it was originally projecting. Because many of the funds that bought in 2009–2011 are back underwater, they are more cautious on new deals. You really can’t blame them, can you?

What is the future of infrastructure funding and CFD financing?

We haven’t done many deals recently that would have benefitted from community facilities district (CFD) financing. Our recent discussions with public builders have been that they prefer to buy small increments of finished or almost finished lots, so they want to shift the market risks and burdens of infrastructure development to us as the land seller.

If you need significant off-site infrastructure funding, the land is probably not ready for development. With the cost of capital and all the other constraints involved, if your land is not near infrastructure, it is probably not economically ready for development in the early part of the cycle. In regard to CFDs, they will remain available, but the timing of the sale of bonds is not as certain as it was in the middle of the last cycle. I would expect to see fewer collateralized deals because land values are low and banks will be loath to provide letters of credit to guarantee the payment of CFD obligations.

Ideally, bond financing of infrastructure remains and grows. Without these financing opportunities, MPCs will struggle and be difficult to underwrite.
All local units of government are broke, and they will look to the developer to fund infrastructure. The municipal finance world can’t sell land bonds on new deals, so if we are to use any type of district or bond financing, we might have to provide the infrastructure dollars up front and then get repaid from a bond offering after the assessed value is created. Another option may be for the developer to purchase the bonds and resell them after the tax base is in place. If none of these options is feasible, we will have to break development down to very small increments to manage the infrastructure exposure.

Municipalities will be much more leery of developers and their promises of what they will deliver. A strong track record of success and impeccable credibility will be essential to forming successful public/private partnerships. Cities and counties are cash strapped and no longer have the financial capacity to step in and address a broken project. Appraisals will also factor heavily into the ability to issue debt for some time. In states like Florida, the new-issue community development district (CDD) market is all but dead for “B” debt and will remain so for the foreseeable future. Also, because new-issue CDD bonds have a statutory maximum rate, bond buyers can still buy “A” bonds on the secondary market at higher yields than new issues while targeting well-performing projects.

Given the above, what is the ideal size, type, and location of financeable deals for the foreseeable future?

The ideal size for a residential development deal would be a project that can be absorbed within no more than ten years and generate a very strong return. Location has to be great, which means that it is directly in the path of growth. Financeable deals will depend upon the resources of the developer.

No more than 200 lots in any one location is the perfect size because near-term absorption is easier to demonstrate. Development in communities will proceed with smaller parcel sizes and infrastructure phases to ensure the capital and lenders that the development is not getting ahead of the market. In planning, you want to be ready to hit the market with sufficient inventory, but you need to avoid black streets with no building activity because obviously your dollars in the dirt are not earning a return. The trick is to achieve the proper balance of “shovel-ready” residential sites and cash in the bank.

During this transition period from the downturn to the next up cycle, the “hot spots” for real estate opportunities are scarce, and very few investments are viable other than, of course, apartments and distressed properties. Having said that, real estate remains a local business, and pockets of opportunity that can be capitalized upon may exist within any market. Perhaps the ideal community development model for the time being is to try to structure a win-win arrangement with a bank-owned (or financed) project where the bank either seller finances or joint ventures a property at above-foreclosure value (and perhaps with a tail-end participation) in exchange for providing on-going development and builder construction financing throughout the project life.
Development will be closer in to the urban core on smaller land acquisitions (about 500 acres or less), located in the larger municipalities, which offer existing infrastructure and access to CFD financing. However, that does not mean that all development will be transit-oriented development, because a good percentage of consumers still want a suburban life style.

Prior to the recession, the ideal size for a typical MPC would have been about 1,000 to 2,000 acres. Now that ideal size for large-scale residential projects has shrunk to a more manageable 500 to 1,000 acres and they are limited to class A suburban locations, with good school districts and proximity to key employment corridors and commercial retail uses.

Although project size may have decreased, preferred locations and other underwriting criteria have not changed.

Portfolios that include several of these opportunities located in a few different markets are preferred, and when holding periods are anticipated to be longer, a clear breakpoint is needed where the project can be sold in bulk to provide an exit for capital partners. Portfolios are the buy of choice for many of the larger equity groups that would like to place $100 million to $200 million at a time and get some diversification for risk.

To secure financing, loans for projects need to be relatively low leverage (leverage for finished lots may carry a higher loan-to-value [LTV] threshold than raw land, but the overall project leverage will be capped at less than 35 percent to 40 percent LTV), with terms of three years or less and a rate of Libor plus 300 basis points, with a floor of 6 percent. Release pricing runs 70 percent to 90 percent of net sales proceeds.

How do you finance projects and enterprises in either business model?

- **Banks**, which previously were the primary source of “A” and “D” debt (securities based on portfolio assets), are not yet back in the lending market. The new debt funds are not really venturing into the land development space either, so it’s all equity funding for now.

- **Banks are starting to lend again**, but the approval process is difficult to navigate. It is back to relationship banking on a smaller scale. Banks will want to see an incredible 150 percent coverage between equity in a deal and personal guarantee net worth.

- **Funding projects are no different than before** but negotiate limitations on the upfront equity investment as much as possible by using public financing opportunities (CFD and improvement districts) to make the deals align with the pro forma.

- **Finding the right capital partner is important**. For equity, it starts by finding a partner with whom you feel comfortable doing business. If a group is extremely aggressive or lacks some of the characteristics you find valuable in a relationship, such as integrity or a team approach to development, that partnership divide will only increase over time. Other red flags may include the appearance of a lack of internal controls or questions about where the money will be coming from.
Private equity will be the first to jump back into real estate finance. Banks and institutions will follow reluctantly, but only once a sustained record of growth, in terms of home and land pricing and absorption rates, is established in the market. Right now small deals will be financed with “friends and family” through their nonperforming IRAs, other retirement accounts, and savings. However, even your parents and siblings are going to want to know when they are going to receive their investment back.

What is the new business model for the relationship between the builder, the land developer, the debt, and the equity?

- In the short term, national and large regional homebuilders will dictate much of what happens in markets because of their significant cash positions and current small margins. Land banking opportunities will be scarce until builder margins widen. It’s difficult to imagine debt being available for much more than ready-to-go small deals for the immediate future. Land development deals will need to support high, unleveraged returns, which are difficult to achieve and are inconsistent with the amount of capitalization required for large, community-level projects. This is not a “new normal”; it is just the way a new cycle starts.

- The relationship between the builder and the land developer will eventually return to what it has been historically. Builders will again be more dependent on land developers to provide them a reliable supply of lots. However, at the present time, the public homebuilders have much more capital available to them than their land developers, and they are therefore, in many instances, developing lots or finishing partially developed lots for themselves.

- The new business model seems to be that the public builders would prefer to stay out of the land development and ownership business and to make their money building houses. If the past is any indication of the future, once the market has improved, the public builders will have forgotten their previous mistakes and again seek to buy larger parcels, complete their own development work, and participate in complicated consortium deals with other builders and a variety of capital resources.

- The relationship will not be too different from in the past. Builders will want developers to have reasonable expectations on returns and allow builders to make some money. In builder pro formas, this reasonable expectation of land value is still referred to as “land residual.” Reasonable deferred consideration opportunities will exist whereby the builder pays for a portion of the land at the retail sale. Traditional bank debt financing will be difficult to underwrite for the foreseeable future. Acquisition loans are nonexistent, and development loans will need LTVs in the 60 to 65 percent range.

- In the words of Ronald Reagan, “Trust, but verify.” Cautious partnerships will continue to exist between developers, builders, equity, and possibly even debt providers. But everyone will go into these relationships being very selective about their partners, recognizing how the parties performed during the tough times. Also, everyone will be extremely cautious and insist on deal structures that limit their downside exposure. Because no one
wants to take risks these days, doing new deals will be a challenge, but they will get done by those who are good operators, who are principled and well capitalized.

- **Everyone will be working for less than they think they are worth**, and each party will expect more input as it works to control its own destiny. Equity partners have shifted from disengaged, long-term pension funds and life insurance companies to short-horizon, actively engaged private equity or international investors. They will want significantly more reporting, more interaction with management and operations, and more control of what happens with the project. Debt providers will also be looking for more in the way of reporting and oversight. For now, at least, velocity of capital is critical, and everyone will want more involvement and control.

The old players have changed, and new relationships will be based on the future rather than on the past, but don’t discount the importance of a successful development track record to attract the largest homebuilders to an MPC. Although initially national homebuilders are capable of funding their own subdivision improvements, eventually land developers will be a source of financing for both private and public homebuilders through rolling options and structured takedowns.

When the banks begin to lend to smaller builders, those builders will be able to show handsome returns on their deals, which will drive them to raise equity to turbocharge their growth. The private builders that adopt this program most successfully will grow significantly and then sell themselves to public builders in three to five years. Public builders are counting on private builders to become larger, because their growth strategy includes mergers and acquisitions.

How do you plan to make money between now and 2015?

- **My first priority is not to lose any more than we already have.** As to making money, we are continuing to focus on developing income properties and particularly apartments for us to hold. We are evaluating our existing land entitlements to see if we have opportunities to reentitle to uses that will result in higher values.

  We have had some success assisting lenders with distressed assets and partnering with landowners who wish to harvest value from their landholdings, and we expect that we will continue to have similar opportunities going forward. Finally, we are a hands-on and detail-oriented company, and as such we should be able to achieve enhanced returns even in difficult times.

- **We are getting into the apartment game.** We are doing a lot of consulting for folks with land that will cover operating overhead now and will provide an opportunity for us to step in as the developer later. We are doing land deals. We may end up developing it or selling it as lots or both. We are cleaning up old deals. We just bought some mineral interests from one of our partnerships that should be a good deal.

- **Under the present (and foreseeable) circumstances, the greatest opportunities lie in selectively purchasing (and reselling) distressed properties.** Now, we are able to invest or borrow $1 million to $2 million to buy fully permitted and largely completed
properties for 30 to 50 cents on the dollar and turn around and sell them tomorrow at below-market prices and make an instant profit. Unfortunately these opportunities are becoming scarce, and we are beginning to look at well-located raw land at distressed prices and, perhaps, joint ventures with landowners or banks, as “normal” development becomes feasible again.

- **We will be partnering with landowners to absorb their land.** We are willing to have an open book and modest return expectations, to be committed to doing quality development, and to be the best operator in the business. We will continue to be a builder of premium homes for buyers willing to spend a little more for what they value. We will not go into the commodity side of the business, which results in an inferior housing product that does not make the world a better place.

We will continue to attract and retain the best people to our homebuilding company, people who are proud of what they do and who want to be surrounded by others with a similar bias toward life—people who want to win the right way.

- **The key to success is to purchase projects in certain submarkets,** where the job and population growth is creating housing demand and thereby reducing the standing or retracted lot inventory, where price appreciation is showing some signs of recovery, and where the submarket is almost ready to accept replacement lot cost pricing, with a reasonable residual land value.

- **Some good advice: focus on smaller projects** (both because of the equity investor time horizon and the desire to complete the project within this next real estate cycle); expand to a range of products that appeal to a wider variety of buyers and increasing points of sale; keep a sharp eye on costs; pay attention to the debt markets and look for opportunities to conservatively recapitalize; expand into other product types; and look for ways to gain better control over cash flow and funding sources.

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By 2014, the business model will morph into a land banking structure to supply production builders with lots. There has never been a time in modern history when more real estate assets were owned by entities that wish they didn’t own them, including banks, investors, stranded developers, and even vulture funds that picked up assets with a game plan to buy and flip. Meanwhile, the industry has purged hundreds of real estate companies out of the business, and only a few strong survivors are in each market area. The survivors will have many people knocking on their doors wanting to sell, partner with, or hire a developer on a fee or participation basis. We will all be in the business of fixing broken projects for the next few years.
Conclusion

During the downturn, many developers have been able to continue to pursue their vision of creating vibrant MPCs because they deleveraged, accumulated cash, and lowered their break-even point. Their financially sustainable real estate model emphasized the importance of cash flow and liquidity, while concentrating on building community value to increase long-term differentiators.

The prolonged real estate recession has increased the barriers to entry to the MPC development business. Most metro area home starts are at the lowest permit volume since the 1960s. The entitlement and infrastructure costs of developing a well-designed community have escalated, and land acquisition and development financing is scarce.

So what does the future hold for MPCs and residential development in general? This discussion paper does not purport to have the answer, but it does offer a number of thought-provoking ideas suggested by ULI members, which outline many opportunities and constraints that will shape communities in the future. Creating a sustainable community, from both a financial and lifestyle perspective, is currently a challenge and, undoubtedly, will continue to be one. However, fulfilling the vision of building high-quality, inspiring places to live that are connected to services and provide access to educational, cultural, and employment opportunities will certainly ensure a community’s overall sustainability and long-term success.