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Land rush

So far has home building recovered from the stygian depths of 2009 that prices are rising even for unimproved dirt without gold underneath. Skipping to the bottom line, *Grant's* is bullish on Mother Earth: for instance, on land suitable for development in Southern California, along the Gulf Coast and on the outskirts of Albuquerque, N.M. And we are bullish on the long fallow equity of a couple of listed land businesses, Amrep Corp. and Tejon Ranch (AXR and TRC, respectively, on the New York Stock Exchange).

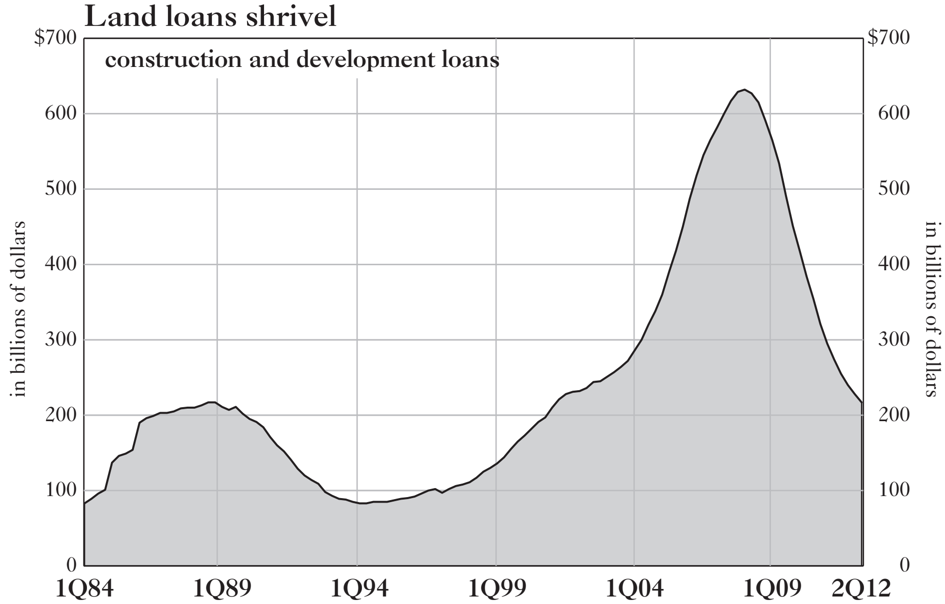
One forgets how great was the collapse in home building. "When the bubble burst," colleague Evan Lorenz points out, "construction activity fell to lows not seen since the Census Bureau began tracking the market in 1959. In previous busts, housing starts fell below the annualized rate of one million for a few months before rebounding to the long-term average of 1.5 million. In April 2009, starts fell to a series low of 478,000, about half the level recorded in a typical downturn. Huzzas greeted news that builders had started 894,000 houses at an annual rate in October, up by 42% from the year before and surpassing expectations of 840,000 starts at an annual rate. Modest, indeed, are the hopes of the bulls."

Then, again, modesty becomes the housing bulls. Nov. 16 brought news, or rather a reminder, of how dependent the market remains on federal subsidies. The Federal Housing Agency admits it has but $30.3 billion in cash reserves to meet $46.6 billion in projected losses. So the agency will need your help, Mr. and Mrs. America. As recently as 2007, the FHA insured less than 5% of new mortgages. In 2008—the year of the failure of Fannie Mae and Freddie Mac and the American subprime lending apparatus—it insured nearly 30% of new mortgages. The agency may now rue that intercession, as no less than 24.9% of the 2008 loan cohort was seriously delinquent—i.e., more than 90 days in arrears—as of June 30. This year, the FHA has insured 14% of new mortgages, which has raised the agency's book of insured mortgages to $1.1 trillion. As it is, the FHA asks a down payment of just 3.5% on the loans it insures. One can imagine its management demanding a bigger down payment, tighter lending standards and/or higher insurance fees in exchange for a likely federal bailout. Such commonsense steps to stiffen FHA's finances will no doubt play better in Congress than on Main Street or at the National Association of Realtors.

Other causes for concern include the so-called fiscal cliff, the continuing credit shyness of America's once-bold bankers, the unresolved problem of American leverage and the still substantial overhead supply of houses awaiting sale as the result of mortgage foreclosures. Conceivably, interest rates could go up (anything is possible). Still, as we say, we're bullish.

It's natural to ask why, in view of the gross overbuilding of yesteryear, there aren't plenty of perfectly fine, previ-

Land loans shrivel



source: FDIC

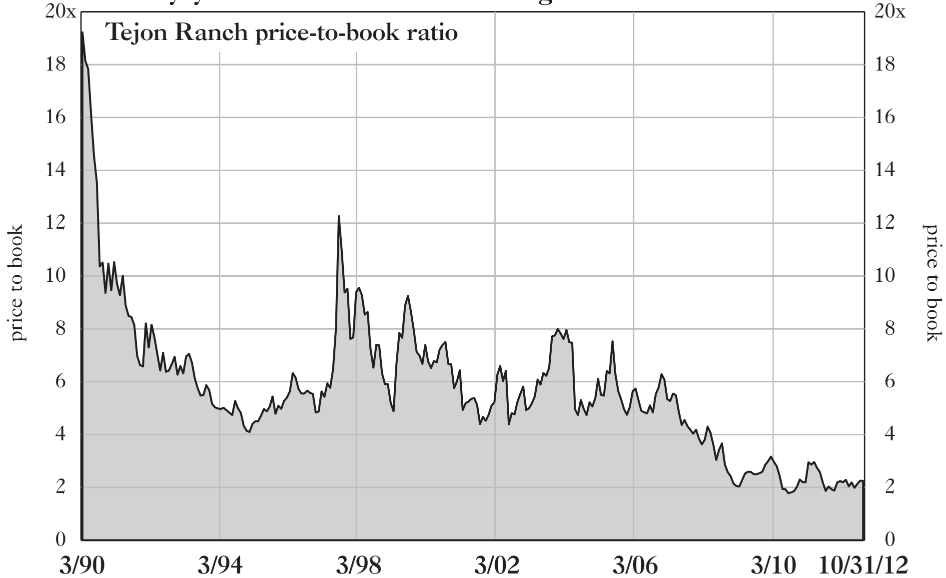
ously lived-in houses to go around without anyone having to build a new one. "Love and marriage, or, at least, cohabitation," is the answer. "The demand has been there," Charles Schwartz, co-chairman and co-founder of Avanti Properties Group, tells Lorenz. "It has been pent up because people don't like to buy a new home and feel that the price is going to drop another 10%. Remember that household formation has been happening, population has been growing throughout this period. Household formations started to increase based on stabilized unemployment."

October 2009 was rock bottom in the setting-up-housekeeping-in-America department. In that month, as homeowners mailed keys back to their banks and moved back into their childhood bedrooms, the number of new households shrank by 375,000 year-over-year. But it's been onward and upward ever since, with the latest reading in September showing a year-over-year gain in household formations of 1,066,000, not far from the past decade's average of 954,888.

The bullish run of news on housing is another prop for land prices. For instance, in the third quarter, seriously delinquent mortgage loans fell to 7.03% from 7.31% in the second quarter. It was the lowest such reading since 2008. Then, too, house prices showed a 3% year-over-year gain in September, according to the Case-Shiller index. It was the fourth consecutive monthly rise.

Even better is the mounting evidence that, as Lorenz puts it, "The invisible hand of the market, as opposed to the very visible hand of the Federal Reserve, appears to be the driver of the upturn in construction." Investment value was the silver lining of the bankruptcy blight. And, as Marvin Shapiro, Avanti president and CEO, points out, opportunistic investors have turned out to be community benefactors. "The markets where there have been more investor activity to buy foreclosed homes," he says, "those markets have recovered faster than markets with less activity. The best example is Phoenix—Orlando is a decent example—where there has been enough investor capital such that housing starts have ramped up to maybe double what they were at the low. It's still pretty low, but it's double what they were at the low. The more those foreclosed units are taken off the market, the more room there is for prices to rise and new construction activity to begin."

Twenty years down—and counting



source: The Bloomberg

Phoenix is indeed a striking example, if only because it is so familiar. And in speculative markets, familiarity breeds, if not contempt, then at least the possibility of overvaluation. According to the Oct. 21 edition of the *Arizona Republic*, 20% of the condos and single-family houses in the Phoenix metro region are in the possession of investors. Prices are bubbly—up 20.4% in September, according to Case-Shiller—and prospective returns, for that very reason, are less so.

One early-bird investor in orphaned houses tells colleague David Peligal that he hasn't bought a property in Phoenix since early in 2012, three years after he started buying there. Assume a $130,000 purchase price, our source proposes (he asks to go nameless). Assume gross rent of $1,200 per month, or $14,400 per year. Now subtract expenses: $1,200 for leasing fees, $1,200 for taxes, $2,600 for fund management fees (our man owns a grand total of 700 houses), $1,152 for property management fees, $1,000 for insurance, $1,200 for rent loss and $1,500 for maintenance. The net boils down to $4,548, for a yield of just 3.5%. Not enough, our informant sums up: "I can't make money on that. My cost of capital is higher than that. We can't get debt at 3.5%. I'm losing money on that house or I'm betting purely on appreciation."

Compare and contrast, please, the CEO of the Ryland Group. "We left Phoenix probably three years ago," Larry T. Nicholson said at a UBS Building and Building Products conference on Nov. 15, "sold out of our inventory when the market was rather distressed and have decided that, long term, that market seems to have got some legs again, so we're going to make a move back into that market." As with a certain kind of rising common stock, Phoenix has passed through the value phase into the growth phase and maybe into the momentum phase. As far as we can tell, however, Phoenix is more exception than rule. In many markets, land prices, though off the bottom, are still in value territory.

For which state of affairs, one may thank, among others, the bankers. At the April 2006 peak in house prices, land loans totaled $486.8 billion. Soon these credits—"acquisition, development and construction loans," to give them their proper title—became notorious. By the first quarter of 2008, $631.8 billion of AD&C loans were outstanding. At the cycle low, the second quarter of 2012, just $217.4 billion were extant, the least since the first quarter of 2001. Thrice burned, the bankers are thrice shy.

A land-investing practitioner, Nathan Cox, partner in the Gulf Coast Opportunities Fund (*Grant's*, June 29) tells Lorenz: "Even if the buyer/developer has tremendous equity, tremendous cash flow, a solid balance sheet, we have not seen banks wanting to get back in that game yet. Land development, AD&C loans, they are just not there yet."

Adds Billy Stimpson, a partner of Cox's in the Gulf Coast fund: "What we are seeing, and this is over the past three to four months, we've seen a big push by specifically the home builders trying to get their hands on as many developed lots as possible. We've seen the supply of busted subdivisions dropping quickly as well as land that is next in line for future development also starting to be absorbed. There's not been hardly any development over the past six years in terms of new subdivisions…. The momentum is in lot prices. We are seeing lot prices move up, perhaps by 10% to 15% from the lows. Home builders are actually raising lot prices over the last four months.

"Whereas six months to a year ago, nobody—I say nobody—very few people were looking at raw land that could be future residential or commercial development," Stimpson goes on. "I would say that has definitely changed and you have numerous interested parties ranging from home builders and investors such as ourselves, to hotel, condominium and retail developers all looking at what's next."

One of these interested parties is the president and CEO of Beazer Homes, Allan P. Merrill. "I am in search of the mythical Holy Grail of 'A' lots that are finished and available on a basis that we can make a reasonable gross margin," Merrill advised the audience at the UBS conference. "I think there are some 'A' locations in all of the markets that we're in that have hair on them. The hair may be that it takes time to get titled, in which case somebody else is going to have to do that. Or it's an 'A' lot that's going to require development work. And that's hair we're willing to take on. . . . I think we've been really careful not chasing secondary locations just to get finished lots to try and drive, I would call it, low quality growth in 2013."

Quoth Toll Brothers' CFO Martin P. Connor at the same event: "We think there's going to be a shortage of lots because, particularly here in the Northeast, nobody's put anything through the approval process pipeline and that is a two- to five-year pipeline." Toll Brothers is sitting pretty, Connor added, but "some of the smaller builders we compete against are capital constrained."

Never mind the absence of AD&C financing or the money woes of the smaller home builders, the prices of finished lots are on the rise. Nationally, in the third quarter, they climbed by 5% sequentially and by 13% year-over-year, according to an Oct. 17 report from Zelman & Associates. Phoenix led in the year-over-year sweepstakes with a 42% leap, followed by the Bay Area and southeast Florida, each up by 30%. Expect a 15% average rise in 2013, says Zelman, "which would correspond to approximately 4% home price gains."

The land underneath apartments and condos, too, has been on the valuation upswing. "Prices for development sites suitable for multifamily development are approaching, or have already exceeded, past peak levels in a few markets but have just started to rebound in most other markets nationally," reports Real Capital Analytics. At the top, land fit for apartment construction commanded $100,000 per buildable apartment. At the lows in 2009, it had slipped to $36,000. Today, it's approaching $80,000.

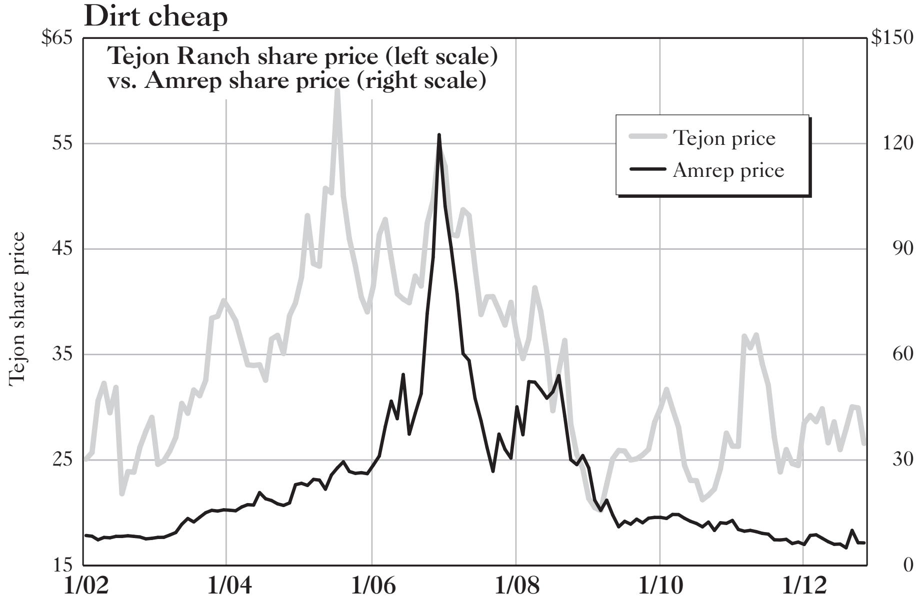
No mystery as to the source of the strength, either, Dan Fasulo, the managing director of Real Capital Analytics, advises Lorenz. "This last five years has been the slowest period in new construction in multifamily buildings in the post-World War II era," he says. Now think about that for a second. You want to know why your rent is going up? It's just the natural order of things."

But give Ben Bernanke his due. Chasing yield, investors have pushed down cap rates. "So you buy an apartment building in Chicago at a 4.5% cap rate," says Fasulo. "You could build a brand-new [residential] community and maybe get 7.5% or 8.5%. That spread is definitely at a multiyear high, and that's basically attracting capital to new development."

Tejon Ranch, the first of our equity picks to click, has not clicked for many a moon. To judge by the ratio of share price to book value, pictured nearby, the market despairs of the company ever clicking. Tejon is the owner of 270,000 acres in California, "the largest private tract of land in the state," and gorgeous and promising acres they are. The rub is that management continues to meet resistance to proceed with its long nurtured plans to develop it (or really a small fraction of it). We refer readers to the Tejon story in the Jan. 27 issue of *Grant's*. Since at least June 30, 2011, a two million-plus shareowner has reduced its holdings to less than 200,000 shares—no small weight on a 20 million-share company that only trades 53,154 shares in a typical day. And Los Angeles County has continued to thwart development of Tejon's Centennial project (nothing new there; the project has languished in the regulatory in-box for more than 10 years).

Then, again, on April 26, the California Court of Appeal, Fifth District, upheld Tejon's plan to build the Tejon Mountain Village. On Sept. 4, the company signed a letter of intent to partner in the development of a suitably high-toned retail outlet center with the

Dirt cheap



source: The Bloomberg

Rockefeller Group, a wholly owned subsidiary of Mitsubishi Estate Co. And on Oct. 10, Tejon filed a shelf registration to issue debt or equity, or a combination thereof, up to $150 million—just in case, the Tejon chief financial officer, Allen Lyda, tells *Grant's*, the need for capital arises in the next three years. Then, too, there's been a pickup in activity on the industrial side of Tejon's business. Farming and oil exploration continue apace. Not the least favorable development since our January analysis is the lift-off in the value of development-worthy land in California, among other places. Not that you'd know it by glancing at the Tejon share price—or, for that matter, the Amrep share price.

Princeton, N.J.-headquartered Amrep once flew high but now—seemingly—can't run, walk or crawl. The company's principal asset is undeveloped land in New Mexico, along with a smaller parcel in Colorado. John Lewis, portfolio manager of Osmium Partners LLC, owner of 9.6% of the company, is well versed in the story of Amrep's descent to micro-cap value stock from beloved high flier.

"The stock has fallen from 140 to six over the past five years," Lewis tells Peligal. "The pendulum has really swung over the last six years from loved by momentum investors as the No. 1 rated idea of *Investor's Business Daily* and valued at six times tangible book value to no interest at half of tangible book value. But they have a pretty indestructible asset, which is that they own 17,350 acres of raw land that borders Albuquerque in the city of Rio Rancho with a population of just under 100,000. The land is a mix of commercial and residential all within city limits. Amrep owns 4,400 acres of contiguous land, which is being developed or is suitable for development, and an additional 2,000 acres where the company owns greater than 50% of the lots in the area. Average home-selling price in Rio Rancho today is just under $200,000. Currently, finished half-acre home lots are on the market for $40,000 to $50,000. Amrep typically sells land to Pulte, D.R. Horton and the other major home builders. . . .

"The reason why the stock is down so much," Lewis goes on, "is that the company has owned this real estate for 50 years, and given recent prices, Amrep sold zero land in the most recent quarter. So the market's essentially ascribed zero value. To compound the problem, or, as we prefer, to improve the investment opportunity, we also have an 80-year-old chairman who is gifting his shares to charity. Anyway, Rio Rancho has a number of attractive characteristics. The average age of a resident is 35, with a household income of $70,000. It's one of the fastest-growing cities in the Southwest, with the population doubling every 10 years since 1990. We think the current market opportunity affords you to pay half of tangible book, which we really think is wildly understated as the land was originally purchased in the early 1960s."

The market loved it when, in 2007, Amrep sold 1,051 of its 17,000 Rio Rancho acres for $91,175 each, for a truly grand total of $95.8 million. Performing the long division, Mr. Market calculated that the company needed only 17 years to liquidate every New Mexico acre. But the sales essentially stopped and the "time to liquidate" has lengthened, if not to infinity, then to—let us call it—800 years. Imagine, Lewis suggests, that you, an apostle of Benjamin Graham, are presented with the opportunity to invest in a depressed cyclical. Its P/E ratio is astronomical. Yet, knowing full well that the time to buy a cyclical business is when the P/E ratio is high, you buy. Same idea here, Lewis says.

But, as Lewis continues, those New Mexico acres aren't all. "Additionally, Amrep owns a magazine distribution business called Palm Coast Data, one of two companies that control 75% to 85% of this market. No question the Palm Coast business is in decline, yet this $83.4 million business generated just under $4.6 million in pretax income in the fiscal year ended April 30, 2012. So for an enterprise value of $36 million, an investor gets Palm Coast Data, 17,350 acres in Rio Rancho, 10 acres of commercial real estate and 160 acres of home sites in Colorado.

"Finally," Lewis winds up, "the company holds no conference calls, does not present at conferences, or do any other kind of investor relations. Over the last several years, the company has paid a $5 per-share special dividend, repurchased $20 million of stock at an average cost of $30 per share in 2008 and acquired Palm Coast Data for $90 million in cash in 2006. The balance sheet is reasonable with net debt of around $1 million."

We are going to say that Amrep will deliver the goods in fewer than 800 years.

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