Avanti Properties Group Investing in land where America grows | Spring 2022 | Issue No.26

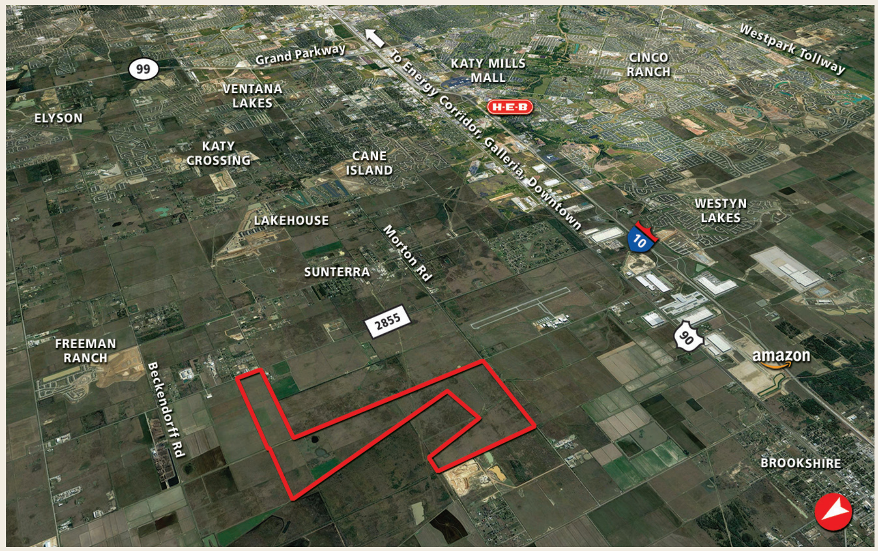
As Rates and Prices Rise, Avanti's Land Excels

Housing affordability is on everyone's mind, and for good reason. In the past year, prices in many of our Sunbelt markets have increased at double-digit rates, and in some cases now exceed rational multiples of household income. And in recent weeks, mortgage rates have risen at their fastest pace in years, while construction costs remain stubbornly high and labor availability persistently low. With interest rates increasing in an inflationary environment, it's natural to ask whether we're headed for a housing slowdown.

In the very near term, the answer to that question is easy: We don't know, so it's best to be prepared. As homebuyers stretch to cope with rising rates and elevated prices, the ratio of household income to price is at its highest in years. Near-term outcomes could include a moderation in prices until wages catch up, a decrease in the pace of homebuilding, or both – ironically at a time when housing is in critical undersupply.

But over the long term, there is a lot we *do* know. And when it comes to investing, there's a lot we can control – if we focus on proven fundamentals, underwrite with discipline, manage risk, and remember that markets can sometimes solve problems themselves. All this means that, at the right price, we remain optimistic investors in the land where America grows, even if the next quarter or year is bumpy, for three reasons.

Featured Acquisition: Freeland, Houston TX



Avanti is pleased to announce its most recent acquisition, a residential community of just over 1,000 acres planned for 2,200 single-family lots in the fast-growing western suburbs of Houston, TX. The community, Freeland, will serve residents who will benefit from access to the region's robust transportation corridors, schools, and key employment centers. As Avanti's 15th investment in Metro Houston, and its sixth with Ersa Grae Corporation, a Houston-based diversified real estate company, Freeland exemplifies Avanti's enduring ability to find deep value in land, even in a rising market.

First, recent affordability concerns notwithstanding, the strong fundamentals helping to drive the current housing expansion are not disappearing anytime soon:

- **Significant pent-up housing demand continues.** Although we're on pace to build 1.8 million homes this year, there still aren't enough for the people who want them, especially in the large, growing, economically diverse Sunbelt markets where Avanti invests. Economists have quantified this shortage: it remains huge at 1.7 million units. With today's rate of starts barely meeting existing demand, we believe it will take several years to work through this nationwide backlog.
- **As the wave of Millennials surges.** Young people comprise a large percentage of first-time and first move-up homebuyers. As the 80 million Millennials born between 1980 and 2000 continue to grow up, the largest age group of this large generation has yet to reach the average first-time homebuying age of 33 or 34. Over the next several years, increased homebuying by Millennials will be a powerful demand driver throughout our markets.

- **In a historically supply-constrained market.** We believe that recent price escalation in the suburban workforce housing market stems partly from large demand in the face of minimal lot supply. In addition, anecdotal accounts of construction delays abound, whether caused by now-routine supply-chain problems or the slow pace of municipal approvals – even nondiscretionary decisions related to engineering, platting, or site planning can take two or three times as long as they used to. Whatever the reason, these delays are adding further pressure to a constrained market.
- **With prudent mortgage underwriting.** After the global financial crisis, home mortgage lenders have lent to consumers more carefully, which itself should provide some floor to potential price declines. Even if the economy were to move into recession, this decade of disciplined underwriting makes mortgage defaults and foreclosure sales much less likely.

Second, while there is much we can't control, investing with discipline shows there is a lot we *can*, including considering risk from Day 1 of due diligence so investments can be made profitable even if slowdowns lead to extended holding periods. Today, for example, underwriting new residential communities should start *not* with studying comparable sales nearby, but with asking what constitutes a reasonable home price relative to household income. Deals relying solely on comparables could prove disappointing if prices have already escalated past what local incomes can afford. Despite the market's powerful demographic fundamentals, prices can only rise so high before becoming unsustainable.

Third, markets themselves can also respond to rising prices over time. For instance, homebuilders who today enjoy some of their strongest profit margins ever might find value by lowering prices to maintain volumes in a rising-rate environment. Similarly, builders and consumers can pursue smaller, more affordable homes on smaller lots. Finally, governments can move faster to approve communities that their constituents can afford if a lack of affordable housing becomes a political issue. Any one of these and other market shifts could ease affordability concerns.

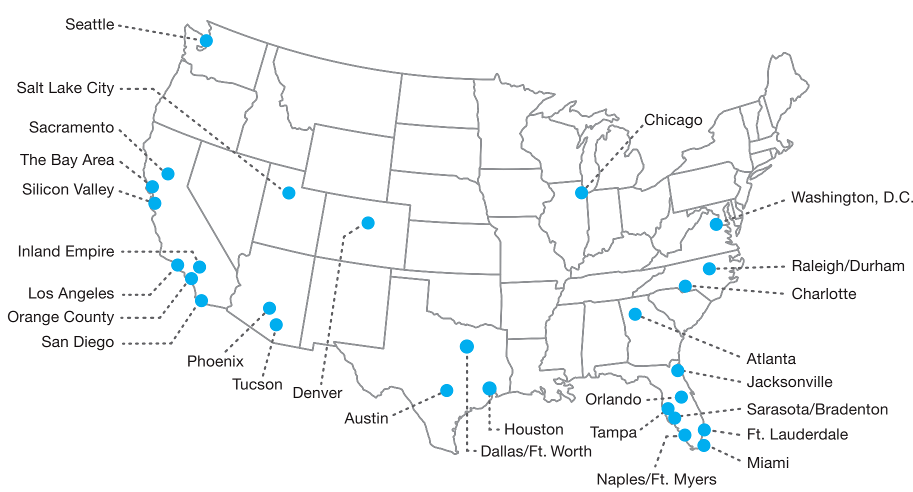
When financial pundits observe "uncertainty in today's housing market," we have to laugh. Are markets ever certain? We prefer investments that are durable enough to perform in all kinds of weather. Short-term land banking deals that depend on builder performance, cost stability, and fast-acting municipalities can deliver returns when the sun is shining, but turn dicey at the hint of a cloud. Strategies that rely on rising rents, low vacancies, and cost moderation can face similar challenges if rates spike. If these bets are amplified with leverage, so too are the risks.

Avanti invests differently. Aside from seeking proven locations close to jobs, schools, and retail amenities, we only pursue investments that offer a deep margin of safety to protect against an uncertain world. This includes 1) buying at a 75% discount to what our future customers will pay, 2) underwriting a rational home price that is reasonably tied to household income, and 3) not taking the risk of leverage. When we can pay 25 cents in hopes of a future dollar, our partners will still be happy if that dollar takes longer to appear than we would like. If inflation grows that future dollar, even better.

As we scour our cities for investments that meet these criteria, we're prepared to pounce when we find them. Even in a rising market, land sellers, developers, and builders find value in Avanti's patient equity capital to provide stability against the news of the day, along with profitable returns as growth prevails over time. Please be in touch!

Sourcing Network and Markets

For 35 years, Avanti has dedicated itself to land investment, focusing on well-located sites in fast-growing metropolitan areas. Today, Avanti owns land that can accommodate more than 45,000 homes in its residential holdings alone. Avanti looks forward to working with experienced local land developers who benefit from having a strong equity partner for medium-term projects requiring $5–$50 million.



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