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Lots of return

With April housing starts leaping by 20.2% and April existing-home sales declining by 3.3%, the American residential real estate market last week was alternately reported to be thriving and dwindling. To clear up any confusion, "thriving," or at worst, "undernourished," is the correct interpretation. We so say on the authority of Marvin Shapiro, chief executive of Avanti Properties Group.

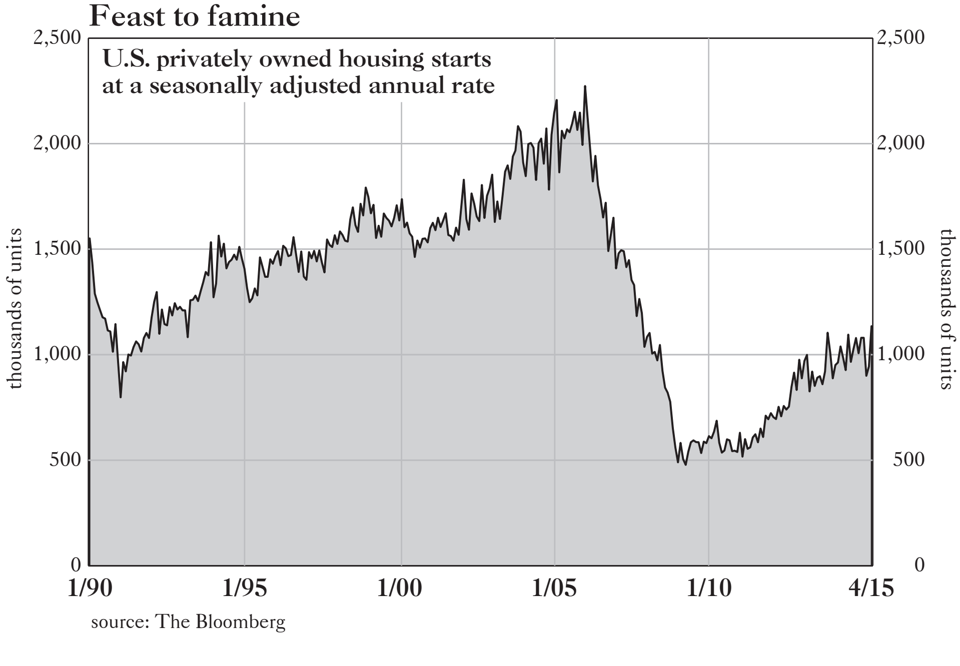
Avanti, a longtime favorite of these pages, is an investment company (minimum commitment: $1 million) that buys land on which buildings grow. Its portfolio features suburban ground on which 45,000 houses could rise up; the value of those acres, priced at cost, is $500 million. On form, the anticipated building will take place, much to the profit of Avanti, which has compounded its investors' funds at the net, unlevered rate of 12.2% per annum over the past 23 years.

If you know what high frequency trading is, you know what Avanti isn't. The Winter Park, Fla., firm buys and holds raw land, among the least liquid of assets. It buys when the price is right and sells, also, when the price is right. Its typical holding period is five or six years. Examining 1,500 or so parcels of land each year for possible purchase, it buys a half dozen. The Avanti commitments' committee could teach a saint the virtue of patience.

David Peligal of this staff e-mailed Shapiro the other day to ask how's business. You can know a lot about interest rates by understanding the direction and trajectory of the American housing market. Then, too, we wanted an update on land prices, which had soared and plunged—and now, again, rallied—with house prices. Building lots may or may not stack up as an "uncorrelated asset class" (that rare bird of plumage), but it's at least an uncrowded and distinctive asset class.

As to the macro situation, Shapiro hewed to the bullish line on which we quoted him in the Feb. 21, 2014, issue of *Grant's* ("Terra frisky"). "We calculate housing demand at around 1.6 million or 1.7 million units per year," he tells Peligal. "That includes household formation, second house demand and obsolescence—with the largest driver being household formation. So even if you took April's number [i.e., starts at an annual rate of 1.135 million a year] as representative of all months, we are still only building to about 70% of our estimate of demand. And this has been the case for a couple of years since the foreclosure pipeline was largely burnt off—so we firmly believe there is a large expansionary period ahead of us, particularly when you combine the current under supply with emerging demand from the 80 million people aged 18 to 32 as they enter their initial home-buying years. Individual market data bears this out. If you look at data for almost any of the major growth markets, excepting Texas and certain land-constrained markets in California, the volume of single-family construction is well under the trailing 15-year average starts, and way under the peak level of construction experienced during the boom. There is an acute undersupply

Feast to famine



source: The Bloomberg

of product at the affordable end of the housing market, which is where we expect the expansion to be most pronounced going forward."

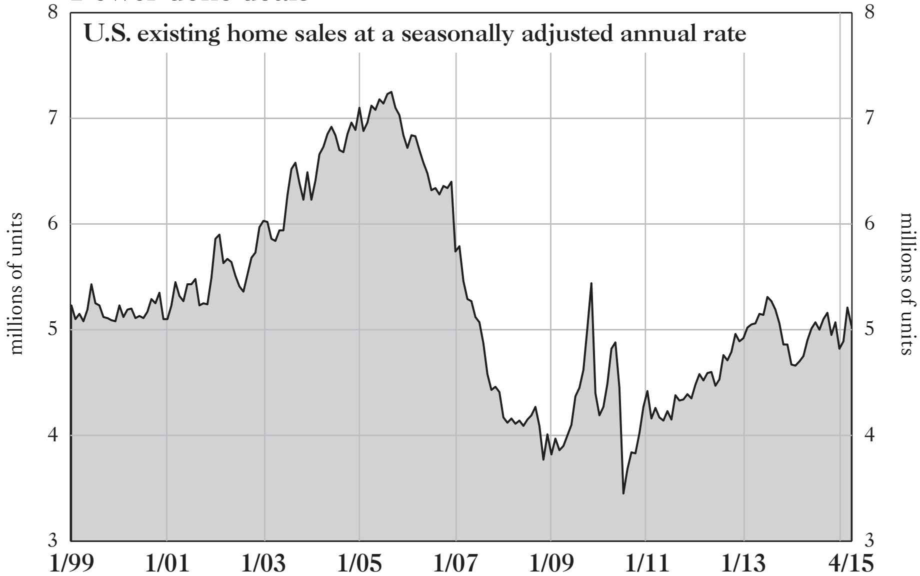
Avanti is in the inter-temporal arbitrage business. It knows, as well as anyone can know, that a certain piece of land will one day fetch a certain price in a sale to a homebuilder. What it doesn't know is when. Knowing that it doesn't know, it seeks a margin of safety in the price it pays. As can be imagined, the waiting and the uncertainty are not for everyone—except, that is, during such once-in-a-lifetime housing booms as the one that flamed out in 2006-07. Shapiro relates that during that manic era, Avanti sold out 80% of its inventory.

Normalcy has more or less returned. "First," says Shapiro, "housing prices have more or less returned to rational levels—rational relative to household income—after hyper-inflating during the boom and hyper-deflating during the bust. And lot prices that the builders pay for those lots or those houses have returned to their standard metric, which, in most of our suburban Sunbelt markets, is around 20% of the value of the house. It's different on the coasts, and it's different downtown, but in the suburban Sunbelt areas, it's about 20%. Second, while the price of medium-term investment land has gone up, probably 20% to 40% off its bottom, it is still less than half the prices builders and others paid at the height of the boom. We are comfortable paying more today than during the recession, because (*a*) lot/user prices have increased, (*b*) we are maintaining our pricing discipline and margin of safety, and (*c*) the market recovery is much more clearly in sight and, therefore, the duration of the investments will likely be shorter."

"At this point," Peligal relates, "I asked Shapiro for a case study. Considering how many opportunities Avanti considers, and how few it partakes of, I happened to be in luck—with breaking news, no less."

"I'll give you an example of an acquisition that is scheduled to close next week," said Shapiro. "We're buying an assemblage of land from six different farming families in northeast Charlotte, N.C., in an area called Harrisburg. The area is well developed with high-quality, move-up priced housing, including a 360-lot Avanti project that is approaching build-out. This new deal is probably the only remaining site of scale in that area—and we could only get it by assembling six different landowners to get to the finish line. Looking at the economics, these houses are probably going to sell in the $350,000 range, which is the prevailing price range for larger lot homes in the area today—including in our own existing development nearby. The land we are buying is entitled for 270 lots, which we believe represents about six or seven years of inventory. The finished lots sold to builders are projected to sell for $70,000, which is 20% of the projected home price. However, since we are buying raw land that still needs to be developed to produce a finished lot, we need to subtract the improvement costs ($30,000 per lot) to derive the user value of the raw land, which is $40,000 per lot. We are buying the land for $10,000 per entitled lot. With entitlements firmly in place, the risk of the investment is purely timing. If in fact the project is developed and sold over a seven-year period, we will hit our target return of 20%. If it moves faster, all the better, but even if it moves substantially slower, we are protected by our low investment basis. The opportunity to invest at this margin of safety is because the user will not buy the 270 lots in bulk—the homebuilder only wants a handful of lots at a time—and there generally are no other buyers of longer-term land. Therein lies the arbitrage—buying in bulk at wholesale and selling at retail over time."

Fewer done deals



source: National Association of Realtors

Avanti's primary focus is raw land for residential development (which stands to reason, as residential is the predominant land use in every market). It's not the only focus. Near the end of last year, Avanti invested in an industrial business park just outside of Chicago, west of O'Hare International Airport and off the Interstate 90 corridor. "We purchased the remaining eight lots of a mature, fully developed business park in Schaumburg, Ill., for a fraction of what we think we can sell for," Andrew Dubill, Avanti's senior vice president of acquisitions, tells Peligal. "This is a park that had been developed, has tenants in it, but there are remnant lots that for which there is no immediate demand, but where there will be strong demand as the national and Chicago economy continues to recover and expand. It's close to thousands of jobs, and it's in a well-established transportation corridor with limited land availability. We were able to invest at under 30% of the rational exit value as each parcel is sold and developed."

Asked for some actual numbers as to what Avanti paid, Marvin Shapiro chimed in: "We paid $2.35 per square foot in bulk, which translates into about $100,000 per acre. We expect to be able to sell the parcels at prevailing retail values of $8 per square foot over the next two to six years, which will produce strong unlevered investment returns and a good multiple of capital."

"In thinking about these Avanti transactions," Peligal muses, "buying residential parcels of land at 25% of their expected selling price (i.e., $10,000/$40,000) and buying commercial parcels of land at 30% of their expected selling price (i.e. $2.35/$8), you wonder what could possibly go wrong. I put the question to Shapiro."

"The downside risk in all of our deals is the lack of growth," he replied. "If there's no growth in a given area, you don't need buildings. And if you don't need buildings, you don't need land. That's the essence of the risk we are taking. Which is why our discipline on location and price is unwavering. Our choice of large-scale, high-growth, well-diversified markets is critical, and our low basis provides ultimate capital protection if for whatever reason growth and absorption of the land are delayed. Keep in mind that our price metrics require that a seller put a huge premium on liquidity to accept our deal, so our hit rate is very low. The vast majority of the deals we look at simply don't sell, but we are able to find a sufficient number of appropriately priced deals per year to sustain a very profitable strategy."

Another concern of Avanti's is whether the real estate crack-up of seven years ago has led to a permanent change in the desire of the average American to own a house. "We are asked," to quote the December 2014 Avanti newsletter, "if we have transformed into a nation of renters. Many wonder whether we are experiencing a paradigm shift in which young people forsake the suburbs for urban areas in which they can 'live, work, and play.' As 80 million millennials—those born between the early 1980s and the early 2000s—move into adulthood, aren't they looking to shed suburban home ownership in favor of renting apartments in cities? And doesn't this fundamental change spell doom for single-family housing and, therefore, investment in residential land? The answer to both questions is 'NO.'"

"The most important factor behind Avanti's rejection of this idea is that most people cannot afford to live in cities," Peligal observes. "Heck, most people would love to drive a Mercedes-Benz instead of a Ford; then again, most people can't afford that luxury. Similarly, the bulk of the housing market simply cannot afford the urban experience. Citing data from Seattle-based real estate provider Zillow Group, a May 21 Bloomberg story notes that rental costs are increasing faster than house values in the U.S. for the first time since 2012. Rents grew by 4% in the year ended April, nudging past the rise in house values, which grew by 3% over the same period. 'There are tremendous incentives to get into homeownership these days: mortgage access is improving, interest rates are low, and home values remain below prior peaks,' Zillow's chief economist, Stan Humphries, was quoted as saying. 'But it will be increasingly difficult for many renters to realize these benefits as this country's growing rental affordability crisis continues to worsen.' As rents in the Sun Belt markets, especially those without reliable public transportation, continue to go up, the suburbs—Avanti's stomping ground—will look better and better."

As Avanti is the anti-high-frequency trader, so, in another sense, is it the anti-New York City luxury-apartment developer. On one of those $10,000 lots in Charlotte on which the firm is expected to close, a 2,800-square-foot house will eventually rise. The house will eventually sell for $350,000, a reasonable price for a two-income family in 21st century North Carolina. The price works out to $125 a square foot.

Compare and contrast the $870 million that Ziel Feldman's HFZ Capital Group is spending to gain control of a single square block in the Chelsea district of Manhattan, "nestled between the High Line elevated park and 11th Avenue and beside Barry Diller's IAC/Interactive Corp. headquarters," as Bloomberg reports. "The deal, completed May 7, was the most expensive New York City lot sale since a partnership including Extell Development Co. paid $919 million for a much larger site on the Upper West Side almost a decade ago, according to Real Capital Analytics Inc."

If the HFZ constructed tower encompasses 300 apartments, each with an average of 1,750 square feet, the asking price per apartment may run to $6.78 million, or $3,875 per square foot. This is not true bull-market luxury—for that, in Manhattan, one would be spending upwards of $100 million. In the case of a contemplated 100,000-square-foot pleasure dome in the Bel Air neighborhood of Los Angeles, one would be spending $500 million. You may call the HFZ apartments starter-titan housing. "How many can afford such a price?" Peligal wonders. "Not sure. Then, again, BlackRock chairman Larry Fink sees Manhattan apartments as one of the best stores of wealth today."

Can Charlotte be so bad?

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