Opportunities in Real Estate Debt

Homebuilder Finance

Housing starts in the US have significantly lagged household formation over the past decade or so, and the country's persistent housing gap has continued to widen. Among the factors driving the lagging supply of new homes has been a shortage of build-ready lots for single-family construction, a fact often overlooked in a country with a land area in excess of 3.5 million square miles.[1]

KEY TAKEAWAYS

- Preparing raw land for new construction can be a lengthy process, tying up homebuilder capital in a non-cash-generating asset.
- Reduced bank financing has pushed homebuilders toward "land-light" business models that use off-balance-sheet financing like land banking.
- Land banking agreements provide home-builders with flexible cash flow management and offer capital providers potentially attractive risk-adjusted returns.

The process of preparing raw land for construction—from design to permitting to infrastructure build—can take two years or more, and this lag can be a financial challenge for homebuilders trying to maintain robust development pipelines without compromising their liquidity and capital flexibility. The reduced availability of traditional commercial bank loans has exacerbated this challenge, and in response many homebuilders have moved toward "land-light" business models that emphasize off-balance-sheet financing solutions like land banking.

In a typical land-banking deal, a capital provider, in exchange for a fee, acquires and holds property on behalf of a builder that has agreed to purchase lots on the property at a predetermined schedule. The two parties also commonly enter into a construction agreement whereby the builder is paid by the land banker to develop the land. A "takedown schedule" governs the pace at which the homebuilder must acquire lots on the property, at a cost that covers the capital provider's expenses plus an appropriate rate of return.

For homebuilders, a land-banking arrangement may serve as a "just-in-time" solution to their land-inventory needs, enabling them to delay cash acquisition and development costs and instead allocate cash to projects already in the construction phase. Builders are typically willing to pay a significant spread over benchmark interest rates for the optionality and off-balance-sheet treatment a land-banking deal affords, positioning capital providers to potentially generate attractive returns that may also serve as a diversifying complement to a range of other portfolio assets.

1. Source: U.S. Census Bureau; data as of December 31, 2020.

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