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# A Perspective on Residential Land Investment

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## Introduction

The following analysis presents an overview of current opportunities in residential land investment. The paper will: 1) highlight emerging trends in residential land investment, noting recent market participants in joint ventures between homebuilders and institutional equity investors; 2) assess market fundamentals of supply and demand at a metropolitan level, evaluating markets that indicate continued strong demand for housing; and, 3) offer a regional perspective as to areas where the greatest opportunities lie.

## Summary of Conclusions

The US is two years into a projected four to five year housing market down-cycle that could be characterized as one of the worst housing-related downturns in decades. Years of easy credit and speculator-fueled excess production have created a perfect storm for the housing sector, which is beset with challenges on all fronts.<sup>1</sup> Given that the US has an excess of approximately two million homes above what is considered normal standing inventory, we estimate another two to three years for about half of the major metropolitan markets tracked by RREEF to stabilize and allow new homebuilding. This over-supply is further exacerbated by the high rate of foreclosures which will further compound the vacant inventory of unsold homes. For both existing and new homes, many markets have already experienced significant price reductions and in the future, further price reductions can be expected. Until these markets stabilize, market fundamentals and economics will not support significant new home construction.

For many dynamic housing markets, demand from homebuilders for vacant developed lots should emerge over the next two years for well located subdivisions. As a result, we believe attractive opportunities will be available to acquire some of this distressed inventory for substantially reduced prices, with the anticipation of a two to three year hold. Transactions to date indicate that finished lots are being acquired at or below replacement cost, not including any land value.

However, for other housing markets, recovery is sufficiently far into the future to make prudent investment difficult. In some metros, housing oversupply relative to projected jobs and household growth is so severe that three or more years will be required before homebuilders are likely to begin new development. Such long time horizons suggest substantial risk, including the distinct risk of another economic down cycle.

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<sup>1</sup> Please refer to "The US Housing Sector in Retreat: The Implications and Projected Recovery", RREEF Research, March 2008.

An enormous supply of finished and unfinished lots exists, held either by homebuilders, third party entities or joint venture partnerships, and financial institutions. Unfortunately, comprehensive data are not available on vacant lots, with the exception of that disclosed by public homebuilders, which represent only 26% of the homebuilding sector. The proxy for supply is an estimate of permits plus under construction vacant units for sale. The proxy for demand or absorption of units is the long term average level of home sales, which will counterbalance the speculator-driven high sales volume. The resulting ratio must be viewed within the context of looming foreclosures and the potential impact these homes will have on home prices.

Runaway land prices in recent years spurred homebuilders to buy or take out option contracts on more lots than were immediately needed. Given the robust pace of land acquisition, inventory growth and general frothiness in the land market, land related markdowns may still have a way to go before finally determining the true market values for those assets. Banks have not begun to see the worst of the real estate returning to lenders.

We believe the opportunities to make solid residential investments will occur over the next year as increasingly motivated sellers come to market at attractive prices. Further, the banks have burned through much of the reserves set aside for the property devaluations and will need to step up the disposition process in the next year.

Where to invest, as usual, depends on the critical balance between demand and supply. Those lots in high growth markets, particularly in terms of job growth and positive demographic trends will absorb excess inventory quickly. However, the supply of vacant homes and lots will also determine the depth and duration of an area's housing market correction.

In addition, the location within a metro of these vacant homes and lots will be critical, particularly in highly oversupplied markets. Put off by rising construction costs and high land prices, and encouraged by a new group of entry level homeowners willing to go to exurban locales, builders strayed from traditional locational fundamentals and built where they could find cheap lots rather than within a reasonable distance of office and employment drivers. In some metros that are otherwise expected to recover quickly, poorly located homes and lots may not be absorbed so quickly, or may require extraordinary price discounts. High fuel prices will exacerbate this problem.

The markets in the Exhibit 1 are grouped according to the level of distress in the housing market as well as future employment outlook. For metros in the first column, which have relatively healthy housing markets, any oversupply should be absorbed within a two year time horizon. Since these markets are not particularly distressed, it is unlikely that steeply discounted vacant developed lots will be available at opportunistic prices. Nevertheless, there could be some attractive opportunities in these markets, where the

Exhibit 1 Years to Absorb Excess Housing Production		
1 - 2	2 - 3	>3
Austin	Atlanta	Jacksonville
Baltimore	Denver	Las Vegas
Boston	Fort Lauderdale	Miami
Charlotte	Los Angeles	Orlando
Chicago	Minneapolis	Palm Beach
Dallas	Oakland	Phoenix
Houston	Orange County	Riverside
New York/New Jersey		Sacramento
Portland		Tampa
Raleigh		
San Francisco		
San Diego		
San Jose		
Seattle		
Washington, DC		

**Distress**

Source: RREEF Research

turnaround horizon is relatively short. Attractively priced opportunities will likely be difficult to find, but overbuilt second tier locations in these markets could be attractive.

We believe the second column of metros will provide the most compelling choices for opportunistic vacant lot investment. The turn around of these markets, estimated to be between two and three years, provides a reasonable investment horizon during a period when we expect reasonably healthy employment and economic growth. Nevertheless, even in these markets, we caution against opportunities that are distant from employment centers.

The third group of markets may have too long of a recovery horizon for investment to be reasonable unless it was a very core location. In these metros, the overall market turnaround will require three years or more, with the risk of the market entering another down cycle. Particular caution should be exerted in examining opportunities in these markets.

## Land Banking Defined

For purposes of this paper, land banking refers to the acquisition of unimproved land or improved vacant lots for the purpose of development or disposition at a future date. This practice is common in the homebuilding industry and allows production homebuilders to secure off-balance-sheet options to purchase land tracts for eventual use in the fulfillment of multi- or single-family housing development pipelines. Historically, this term has primarily been applied to unimproved, or raw, land that sits in the anticipated path of growth, still considered to be at least a decade away. In recent years, the term has referenced improved vacant lots held by a third party entity for homebuilders, who have option agreements to take down these lots as needed. This has allowed for the more efficient use of capital by increasingly sophisticated homebuilders.

In anticipation of future development, investors may purchase and hold land that is vacant, rural or underutilized at a relative low cost in anticipation of significant value increases as the location emerges in the path of development.

Generally, the price at which investors or builders acquire land or lots is distinguished not only by its location, but also the level of improvement or development. For example, “paper lots” refers to sites that are vacant and approved by the local zoning authority, but construction on streets, utilities and other infrastructure has not commenced.

“Blue Top Lots” indicates an interim stage of lot completion. In this case, the owner has completed the rough grading of the property and the lots, including the undercutting of the street section, interim drainage and erosion control facilities, and has paid all applicable fees required. At this stage, the homebuilder can obtain a building permit upon payment of the ordinary building permit fee.

“Finished Lots” are fully completed, ready for home construction and occupancy. The lot may be “finished” either before or during construction of the home. All entitlements, infrastructure to the lot, finished grading, streets, common area improvements and landscaping have been completed. All development fees, exclusive of the building permit and inspection, have been paid.

## Market Participants & Strategies

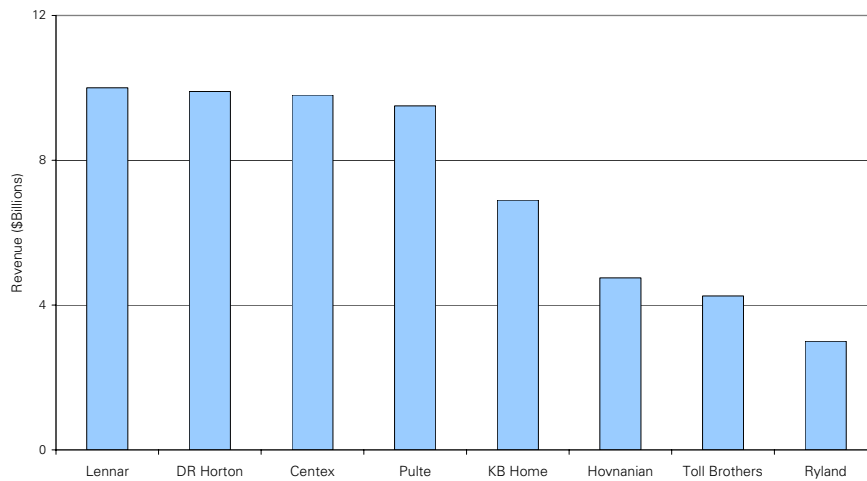
Market participants in residential land investment generally fall into one of three categories: homebuilders, equity partners, and banks. In times past, homebuilders used to bank land and develop lots for their own account. As they have become increasingly sophisticated public companies, they have largely changed this practice, relying upon joint ventures or third party

investors to bank land for them. These investors have provided much of the paper and finished lot inventories to homebuilders on an as needed basis. Even so, some homebuilders have moved well ahead of demand in taking down some of this inventory.

With the current housing oversupply crisis in the US, there is an enormous surplus of lots, held either by homebuilders third party entities, or joint ventures. As the depth of this crisis has unfolded, some owners' have been selling to opportunistic investors. Their investment plan is to purchase these surplus lots at a discount in distressed markets and hold them until the market recovers and builders once again need them. Notably, not all buyers are investors; some homebuilders may purchase steeply discounted lots to gain a competitive advantage, coming to market later with finished lot costs well below actively selling competition. In a downturn, site improvement costs can make raw land development unprofitable because builders should be able to purchase investor lots at lower prices. This hurts land developers who specialize in developing and entitling lots and then sell them at a higher price to the builder. The recent upswing in investor lot acquisitions should help counterbalance the supply distress by removing lots from the market; fewer lots available redirect buyers to the standing inventory of new homes.

**Homebuilders** – The universe of homebuilders is large and fragmented. There are approximately 80,000 to 90,000 homebuilders in the US; 20 are publicly listed companies and only 10 of significant size. For purposes of the market participant discussion, we draw upon public homebuilders, because data is more readily attainable and transparent. The top 10 public homebuilders accounted for an estimated 26% of all new homes sales in 2006, up from 11% in 1997, as some smaller builders have exited the market.<sup>2</sup> Exhibits 2 and 3 below rank the largest builders by revenue and number of closings to offer a perspective of the influence of the homebuilding sector.

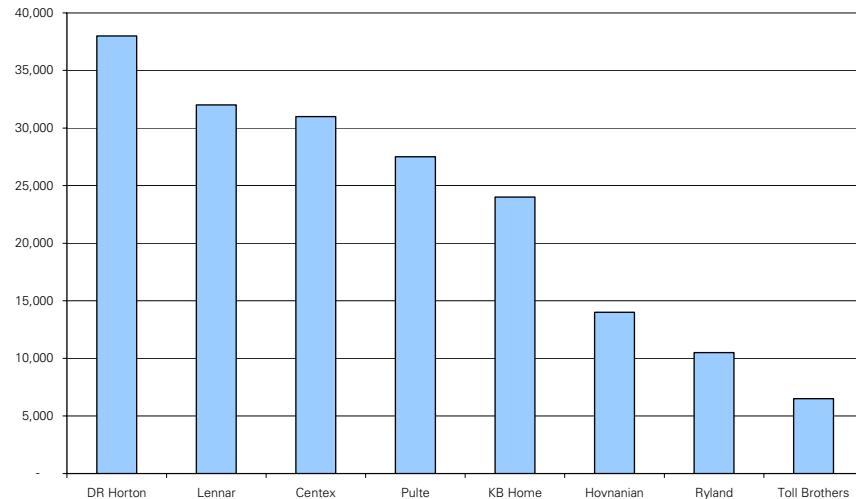
**Exhibit 2**  
**Top Public Homebuilders Ranked By FY 2007 Revenue**



Source: Lehman Brothers estimates, Company reports and RREEF Research

<sup>2</sup> McGrath, M. and M. Lambdin,, "Homebuilders", March 18, 2008, Lehman Brothers.

Exhibit 3  
2007 Closings by Builder



Source: Lehman Brothers estimates and RREEF Research

Most large US homebuilders have responded to the severe housing downturn by shoring up their balance sheets, renegotiating or paying down their debt and strengthening their cash positions. Most have substantial inventories of completed or partially completed homes that need to be sold quickly at steep discounts. Many have aggressively discounted and sold land to partners in newly formed joint ventures, while retaining a (reduced) equity interest and negotiating rights to repurchase the land at some future date. Further, the enormous write downs and steep discounts have generated tax refunds that can exceed the sale price.

A significant amount of land is controlled through lot option contracts, which allow a homebuilder to put down a deposit or letter of credit during the approval and entitlement process, thereby reducing cash flow and balance sheet risk. Many builders are declining to exercise these options, leaving many land sellers and banks holding excess inventories of undeveloped land.

The 10 largest public homebuilders reduced their lot holdings by the end of 2007 by 39%, with the majority of the decreases coming from the write off of land options, especially if the companies were unable to renegotiate or extend the terms of the option contracts. Option lots were down 59% year over year and will likely continue to decline with the homebuilders still holding an average of 35,000 option lots per builder.<sup>3</sup>

**Joint Ventures** – Homebuilders often enter into joint venture partnerships with other homebuilders or equity partners in an effort to mitigate risk or share knowledge and expenses due to the size and scope of certain land development projects. During the housing boom, it was not uncommon for builders to enter into joint venture deals to share the cost of buying expensive land. The ventures typically allowed the builders to keep such highly leveraged land off their balance sheets.

The purpose of JVs varies, but typically they will develop land and sell it back to the JV participants for homebuilding purposes; develop land to sell to third parties; or, construct homes to sell to third-party homebuyers.<sup>4</sup>

<sup>3</sup> Puryear, P., Horne, B. and Ross, K., Housing Quarterly, Spring 2008, Raymond James & Associates, Inc., April 9, 2008.

<sup>4</sup> McGrath, 2008.

Joint venture liabilities, such as debt and letters of credit outstanding (sometimes issued in lieu of option deposits), are often considered off-balance sheet liabilities. These joint ventures can raise the risk and leverage profile of the builder partly because each builder is potentially responsible for a share of the obligations of the joint venture. If one or more partners fail, the other builders could be liable for additional equity contributions and loan obligations. Please note that the members bring significant equity value to the joint venture.

Lehman Brothers recently reported three key, high profile joint ventures that are in various stages of financial distress: LandSource, Kyle Acquisitions, and Inspirada. A brief description of each is provided in the Appendix of this report to illustrate the types of contributions the members make and the variety of activities in which the JV engages.

### ***Institutional Equity Buyers/Partners and Recent Transactions***

Many institutional investors have begun buying residential land at steep discounts. By some estimates, the value of residential land nationally has declined by 25% to 30%. Many portfolio transactions reflect even larger discounts. Investment is made vis-a-vis recently emerged specialized distressed residential land funds as well as diversified real estate funds. Large institutions, notably the California State Teachers Retirement System (CalSTRS), Los Angeles County Employees Retirement Association (LACERA) and the Stanford University endowment, have already committed capital to residential land funds. CalSTRS reportedly has set aside \$1.5 billion for residential land, of which \$200 million has been invested. LACERA noted that \$137 million of a \$300 million commitment has also been executed.<sup>5</sup> Following are a few "headline" transactions.

- Centex recently sold a portfolio of 8,500 lots in 27 neighborhoods across 11 states, but mostly concentrated in California and Nevada, which represented about 10% of its land holdings, to a joint venture of financial partners that includes Dallas-based RSF Partners and San Francisco-based Farallon Capital Management. Centex carried the land on its balance sheet for \$528 million, more than three times the \$161 million sale price. Some analysts estimate the transaction cleared at \$0.16 on the dollar. Notably, the sale generated good liquidity and will also trigger an additional \$294 million tax refund. Centex retains a 5% interest in the JV and has the right to receive a greater share of the profits if certain financial targets are met. Included in this sale is Plant 51, a 265-unit condominium located near downtown San Jose, which is reportedly 70% complete. Centex failed to sell a single unit after spending \$100 million over the last four years.
- Lennar sold nearly 20,000 home sites nationwide in recent months. Tampa-based Metro Development Group LLC paid an undisclosed sum for 8,300 home sites in seven counties in Florida, including 1,200 lots in Central Florida. In addition, Lennar formed a new land investment firm with the real estate arm of Morgan Stanley & Co., MSR Holding Co. Lennar sold 11,000 home sites in 32 communities throughout the country to MSR for about \$525 million. The properties reportedly had a \$1.3 billion book value as of 3Q07. Lennar retains a 20 percent interest in MSR and the option to buy back the sites in the future.
- A joint venture between Pulte and Centex sold property in Rancho Cordova (Sacramento) for a reported sale price of \$8 million to local land developers in February this year. The original purchase price by the JV was \$50 million in 2004. The recent sale reflects a discount of \$0.16 on the dollar, before tax recovery benefits.

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<sup>5</sup> Jacobius, A., "Residential Land Sale of 2008", Pensions & Investments, March 3, 2008.

- Resmark acquired 604 home sites in Southern California for \$90.5 million from William Lyon Homes in Newport Beach, California. The properties had a book value of \$210.7 million. The transaction represents a value of about \$0.43 on the dollar.

As Merrill Lynch noted in a recent report, builders long on land may continue to execute land sales through the joint venture strategy. The tax refunds generated by these sales continue to support these builders as illustrated in Exhibit 4 below. The example refers to the recent Centex/Pulte sale in Sacramento as noted above. The differential between the original acquisition price of \$50 million in 2004 and the recent transaction price of \$8 million nets approximately \$0.16 on the dollar and suggests a loss of \$42 million. Applying tax refunds for the inflated values in prior years implies a \$15 million tax benefit and a recovery more in line with \$0.45 on the dollar.<sup>6</sup>

The tax recovery benefit to the seller also shifts a greater share of risk or exposure to the buyer as they must peg their investment returns to future timing and price assumptions.

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**Exhibit 4**  
**Tax Refunds Generate Economic Value**

Sacramento Land Sale (as reported)	
Original purchase price	\$ 50.00
Cents on the dollar received	\$ 0.16
Sales price	\$ 8.00
Loss	\$ (42.00)
Implied tax benefit	\$ 15.00
Economic value recovered	\$ 23.00
Cents on the dollar recovered	\$ 0.45

Source: Merrill Lynch estimates and Sacramento Business Journal

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Finished lots near a major metropolitan area are safer investments than raw, undeveloped land. Homebuilders rushed in and bought the most desirable sites located closer to urban centers, bidding up the land prices in the process. Owners will likely have expectations of more modest discounts for those lots. Lots in ex-urban areas face the steepest discounts because their development is longer term, which implies higher risk, and possibly more expense as building paved roads and providing electricity and sewerage can be disproportionately borne in a pioneering effort. Unfinished lots will also face the steepest discounts.

***Banks (and Real Estate Owned)***

As noted earlier in this report, public homebuilders account for approximately 26% of sales revenue, representing a high concentration of revenue for such a small group. 74% of new home sale revenue must be spread throughout a variety of smaller, regional and local homebuilders across the country, who will presumably face even greater constraints for tapping into capital and forming joint ventures. Many industry analysts expect that these smaller builders will be giving back land in growing numbers throughout 2008, which will hit banks' balance sheets by year end. Most banks have already established restructuring groups

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<sup>6</sup> Zener, K., "Land alchemy? No tax refund: How 16 cents turns into 42", Merrill Lynch, March 7, 2008.

to help quickly dispose of these assets. Given the robust pace of land acquisition and inventory growth over the last several years and general frothiness in the land market, land related markdowns may still have a way to go before finally determining the true market values for those assets.

## Current State of Housing Fundamentals

As 2007 ended, the US housing market entered its most significant decline in decades, the result of several years' worth of over-investment in and over-production of housing. Sales volume is down 30-40% in a broad swath of markets and prices are falling. Continued deliveries, lower prices and rising defaults and foreclosures are combining with tighter credit conditions to further weaken prices. Falling home sales and starts generally lead the decline in home prices so a further decline is likely. The combination of a 23% decline in sales, existing home and continued production of new housing units resulted in a 54% increase in the inventory of unsold homes as of January 2008.

Exhibit 5 reflects the effect sales inflated by speculators and second-home buyers had on new construction. Builders responded to this unprecedented demand by delivering nearly 2.0 million units in both 2005 and 2006, driving the spread between actual demographic need as determined by household formations and unit deliveries to new highs.

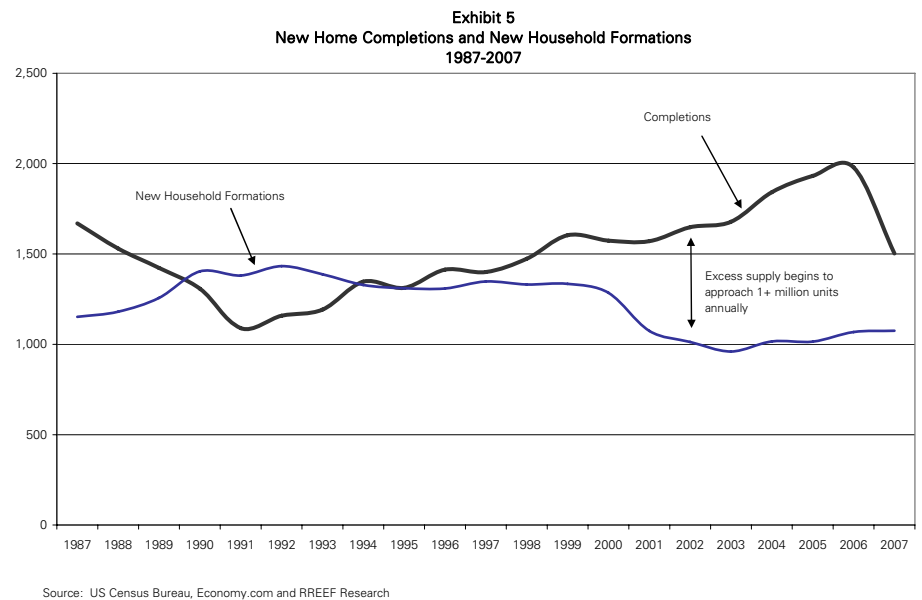
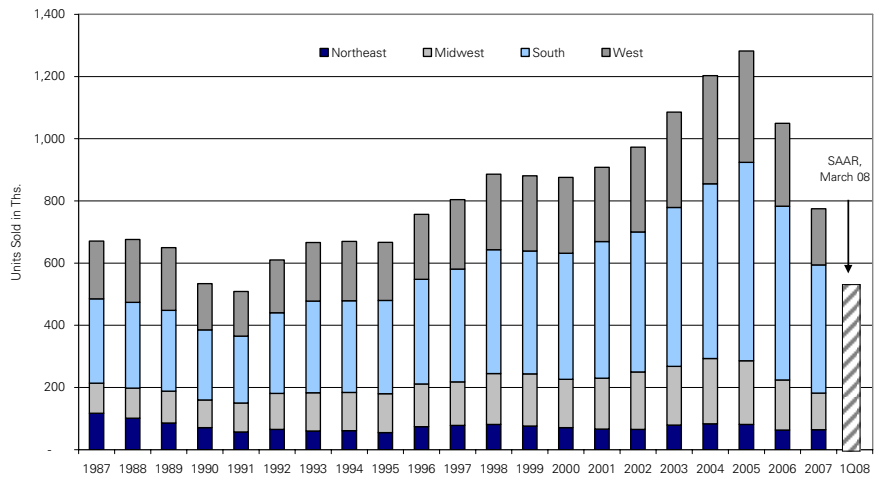


Exhibit 6 depicts sharply declining new home sales for March 2008. Sales were at a seasonally adjusted annual rate (SAAR) of 526,000, representing a year-over-year 37% decline and the worst pace in 14.5 years. The worst declines were in the Northeast (65%), Midwest (50%), West (39%) and South (26%).

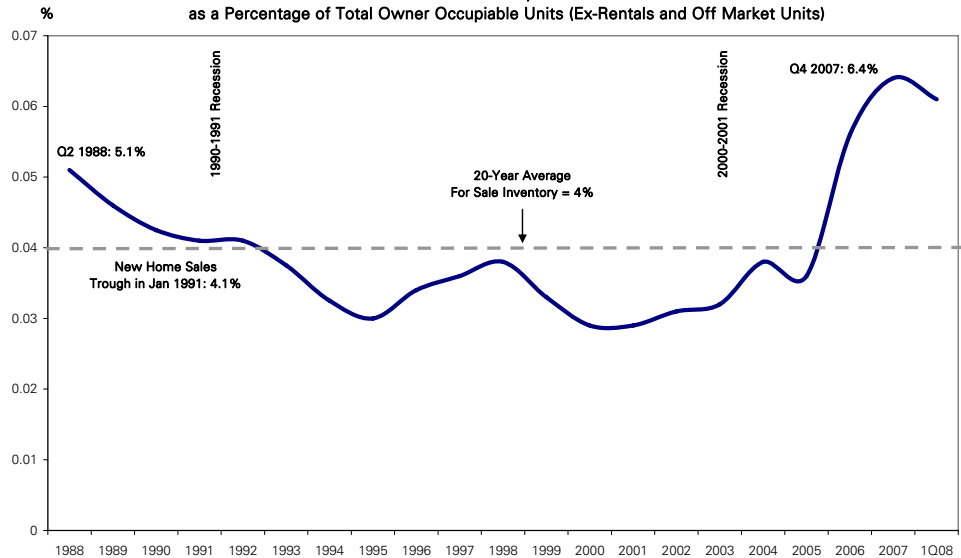
**Exhibit 6**  
**New Home Sales by Region**  
**1987 to 2007**



Source: US Census Bureau & RREEF Research

Exhibit 7 highlights the severity of the supply side issues and compares the current housing downturn to the 1987-1991 housing cycle, which appears comparable in depth and magnitude. The conclusion we can draw is we are still near all time record levels of inventory relative to the past 20 years of documented history. This translates to approximately 4.0 million existing homes for sale, plus roughly 471,000 new homes for sale, and implies that we are 1.6 million units above the long term trend.<sup>7</sup> The new homes available for sale are provided by the Census Bureau, which does not capture the effect of cancellations. We believe the actual number could approach two million units.

**Exhibit 7**  
**For Sale Inventory 1988-2007**  
**as a Percentage of Total Owner Occupiable Units (Ex-Rentals and Off Market Units)**



Source: Raymond James & Associates, National Association of Realtors and Census Bureau

<sup>7</sup> Puryear, 2008. Note: The denominator adds total owner occupied homes plus vacant for-sale single-family units, which amounted to approximately 77.3 million homes as of 4Q07.

The latest reading in new single-family home sales came in at a 14.5 year low annualized pace of 526,000 units. Assuming *zero new housing starts*, and assuming a reversion to between 700,000 and 800,000 annual new home sales, it would require between 2.5 and 3.0 years to clear the excess inventory of homes, allowing the market to stabilize and restore confidence in the sector. Only then will home values stabilize and allow new home construction to resume.

Drilling down to a metropolitan level, if Exhibit 8 is considered to be broadly representative of housing conditions across the US, the market is clearly in disequilibrium, with Central Florida and Las Vegas facing the worst impact. Generally, existing sales trends indicate little market liquidity and the months' supply reveals an above-trend supply of standing inventory. Further, anemic job growth reflects weaker demand in the US, although healthier employment growth in the selected markets than the US.

**Exhibit 8**  
**Local Housing Market Conditions for Selected Markets**  
**January 2008**

MSA	Monthly Supply (Jan)	Year-over-Year % Change		
		Existing Sales	SF Permits	Job Growth
1 Orlando	34.0	-49%	-33%	2.3%
2 Tampa	30.1	-27%	-18%	1.0%
3 Las Vegas	23.9	-33%	-70%	0.8%
4 Riverside	19.9	-20%	-69%	2.5%
5 Phoenix	19.6	-34%	-53%	1.3%
6 Tucson	15.4	-36%	-49%	1.8%
7 Minneapolis	14.3	-21%	-65%	0.1%
8 Sacramento	14.2	-20%	-55%	0.3%
9 Baltimore	14.1	-40%	-50%	2.3%
10 Charlotte	13.6	-23%	-61%	2.1%
11 Wash, DC	13.2	-37%	-18%	1.4%
12 Albuquerque	12.9	-37%	-41%	0.9%
13 Raleigh	11.5	-29%	-28%	1.8%
14 San Antonio	10.5	-17%	-49%	2.0%
15 Houston	10.1	-15%	-26%	2.4%
16 Indianapolis	9.8	-18%	-47%	1.1%
17 Dallas	9.4	-18%	-34%	2.2%
18 Denver	8.2	-16%	-56%	1.6%
19 Austin	7.2	-12%	-15%	3.1%
<b>Median of Markets</b>	<b>13.6</b>	<b>-23%</b>	<b>-49%</b>	<b>1.8%</b>
<b>US</b>	<b>10.3</b>	<b>-23%</b>	<b>-40%</b>	<b>0.8%</b>

Source: Merrill Lynch, National Association of Realtors, Census Bureau, BLS and RREEF Research

Notably absent from the list are South Florida metropolitan areas. The months' supply is a figure reported by the National Association of Realtors (NAR), which includes existing homes only. Arguably, South Florida metros are more affected by the daunting level of new condominiums completing in 2008 and 2009, particularly in light of recent changes in the mortgage markets and plummeting home values. It is still too early to see how many buyers will walk away from the 5% equity payment or make an additional 15% down payment to consummate the sale. Anecdotal evidence suggests that pricing on many mid-market condominiums is down 40% to 50% from the peak of pricing.

Dallas, Denver and Austin appear to be healthier housing markets. Existing supply exceeds historical trend for these markets, but certainly they benefit from continued better-than-average job growth and that homes did not have runaway price appreciation, so there is no outsized deflating effect of a pricing bubble.

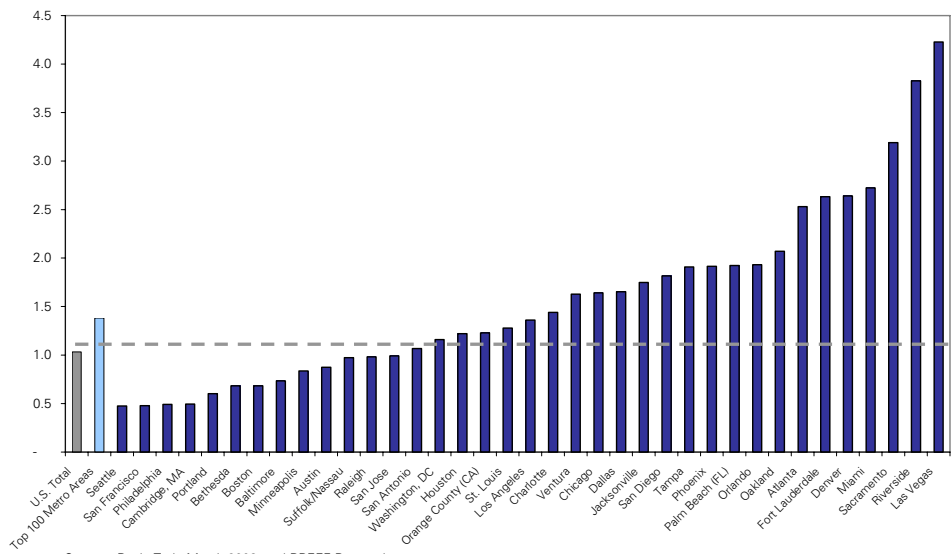
## The Outlook for Residential Land Investment

Arguably, the US is two years into a four year housing down-cycle that could be characterized as one of the worst housing-related downturns in decades. Years of easy credit and speculator-fueled excess production have created a perfect storm of sorts for the housing sector, which is beset with challenges on all fronts. Listed below, in no particular order of importance, they include:

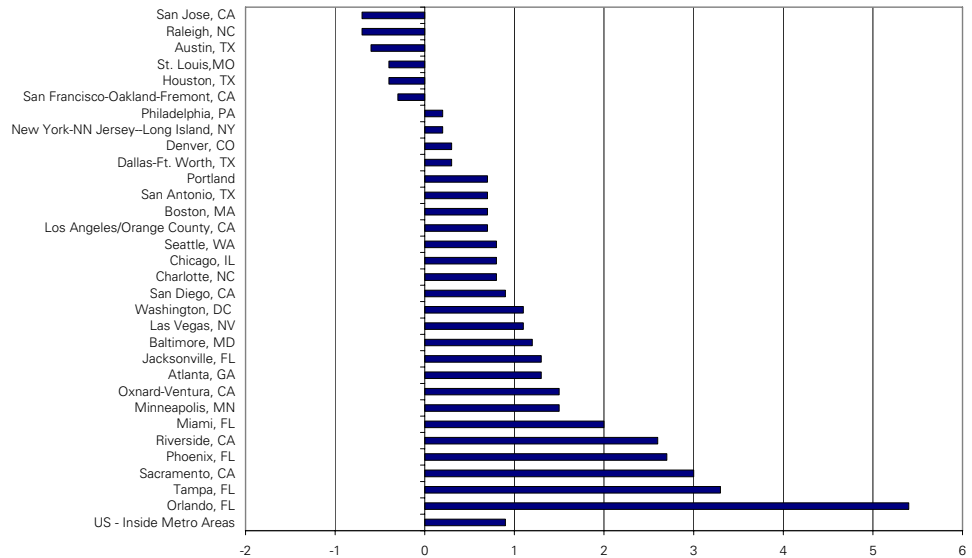
- 1) a lack of consumer confidence
- 2) declining homeowner equity
- 3) mortgage market dislocation and tightening of mortgage availability
- 4) heavy price discounting on new homes
- 5) increasing foreclosure rates exacerbating supply issues and rising delinquencies and, more recently,
- 6) job losses/recession

This particularly bleak snapshot in time is just that - a snapshot of current conditions and it looks as we expect it should. Exhibits 9 and 10 reflect the markets that will be working through the highest levels of foreclosures and therefore inventories of unsold homes. Homebuilders flocked to these markets because of their big job numbers and explosive population growth. Investors did the same because they were relatively inexpensive places to buy and flip a property. A healthy level of employment and price correction needs to occur before homebuilding becomes profitable again in markets like South and Central Florida, Las Vegas, Phoenix and Riverside, particularly in light of continuously rising construction costs.

**Exhibit 9**  
Percentage of US and Selected Metro Households in Foreclosure



**Exhibit 10**  
**Homeowner Vacancy Rate Change 2005-2007**



Source: Census Bureau and RREEF Research

Looking forward we assume the current economic downturn is truly a mid-cycle correction and not a protracted recession. The recovery in employment in tandem with a big increase in affordability across most markets could bring with it a resurgence in home sales, but consumers have no real impetus to seek a home at the moment. The job market is unsteady and home prices are still falling; they are likely waiting for the bottom of the market and a firming of the economy. There may be renters who jump into homeownership when prices realign with incomes. Home price appreciation surged three to four times ahead of income growth in each of the past four years, but already adjustments in affordability are found in various markets. As Exhibit 11 shows, some of the markets with the highest rates of runaway appreciation have had the sharpest adjustments in affordability. This price adjustment and lower mortgage rates will help spur home sales when consumer and business confidence returns.

Exhibit 12 reflects a consolidated ranking of metropolitan markets based upon economic drivers. Clearly, this shows the same markets homebuilders preferred in the past at the top of the list, while the more expensive markets with arduous entitlement processes are located near the bottom. Miami is near the bottom of the list because of slower job growth projections but it will continue to attract builders in the future because of its role as an international gateway city.

Buying land as an opportunistic institutional investment strategy depends largely upon the location and degree of improvement of the assets, timing/investment horizon, the expertise of the buyer, confidence in the pricing, interest rate assumptions, the standing inventory of existing and new homes, available finished lots and numerous other considerations. Peripheral or exurban locations are generally less desirable than locations closer to employment centers, and will take longer to absorb.

The decision of where to invest cannot be determined at a metro level; many submarkets are unique with great variation. It requires dedicated ground level due diligence to estimate the supply of land and homes, and current and expected future values of land and home prices. Many homebuilders solve for a 20% IRR in core areas, but given the state of some markets and for ex-urban locations, that return may leap to 30%. Land investment is a specialized business given the longer term hold of the investment and the difficulty in quantifying the

**Exhibit 11**  
**Selected Metropolitan Areas Ranked by Change in**  
**Affordability from Peak to 2007**

		Affordability Index		4Q2007	Chg from
		Date	Min	Level	Peak
Sacramento	CA	2005Q4	71	96	35.5%
West Palm Beach	FL	2005Q4	58	77	32.5%
Riverside-San Bernardino	CA	2006Q3	58	75	30.7%
Oxnard-Ventura	CA	2006Q2	62	80	29.3%
Los Angeles	CA	2006Q3	44	57	29.1%
San Diego	CA	2005Q4	47	59	26.1%
Tampa-St. Petersburg	FL	2006Q2	98	121	22.7%
Fort Lauderdale	FL	2005Q4	65	77	17.5%
St. Louis	MO	2006Q3	171	200	17.2%
Orlando	FL	2006Q2	86	100	16.3%
Minneapolis-St. Paul	MN	2006Q1	137	159	15.9%
Phoenix	AZ	2006Q1	88	101	14.7%
Denver	CO	2006Q2	124	141	14.3%
Boston	MA	2006Q2	91	103	14.1%
Miami	FL	2005Q4	54	61	13.0%
Santa Ana	CA	2006Q3	48	54	12.9%
Atlanta	GA	2006Q3	144	162	12.8%
Chicago	IL	2006Q3	100	112	12.0%
New York-No. New Jersey	NY	2006Q3	64	72	11.6%
Washington DC	DC	2005Q4	85	95	11.6%
New York-White Plains	NY	2005Q4	49	53	9.8%
Seattle	WA	2007Q2	79	87	9.5%
Charlotte	NC	2007Q3	128	138	8.0%
Dallas	TX	2005Q4	162	174	7.4%
San Francisco	CA	2007Q3	44	47	6.9%
Houston	TX	2006Q3	165	177	6.7%
Oakland	CA	2007Q3	47	50	6.6%
Nashville	TN	2007Q3	142	150	5.5%
Philadelphia	PA	2006Q2	131	138	5.4%
Baltimore	MD	2006Q4	114	120	5.4%
Portland	OR	2007Q3	94	99	4.8%
San Antonio	TX	2007Q3	142	147	3.7%
San Jose	CA	2007Q3	48	49	3.0%
Austin-Round Rock	TX	2007Q3	140	144	2.8%
Raleigh	NC	2007Q3	131	131	0.4%
<b>US</b>		<b>2006Q2</b>	<b>126</b>	<b>140</b>	<b>11.1%</b>

Source: National Association of Realtors, Economy.com, and RREEF Research

supply-side risk. The only way to proceed is submarket by submarket, for there is no proxy for quantifying finished lots suggested by industry analysts. Given current housing conditions, raw land would be the riskiest venture and entitled, finished lots would be the safest. In this past housing boom, builders began building where they could find cheap lots, not where the fundamentals supported new homes. These developments are at great risk, whether they are unfinished or finished lots; the absence of a strong job market and solid household growth will result in a protracted recovery period and falling values. Markets in core areas that have solid economic infrastructure to support home building will weather the storm better than those with flimsy demand drivers.

**Exhibit 12**  
**Consolidated Ranking on Economic Measures, 2009-12**

		Total New Jobs, 2009-12		Avg Annual Job Gwth, 2009-12		Total New HHs, 2009-12		Avg Annual HHs Gwth, 2009-12		Avg Annual Med HH Y Gwth, 2009-12		Total 2009-12 Rank	
			Ranking		Ranking		Ranking		Ranking		Ranking		
1	Atlanta	GA	209.42	2	2.70%	3	137.0	3	2.23%	11	4.33%	1	20
2	Dallas	TX	162.38	5	2.45%	6	112.7	6	2.36%	9	3.26%	4	30
3	Houston	TX	179.72	3	2.24%	10	149.2	2	2.34%	10	2.89%	9	34
4	Austin-Round Rock	TX	66.14	17	2.73%	2	60.3	14	3.14%	2	3.28%	3	38
5	Phoenix	AZ	138.29	7	2.28%	9	130.8	4	2.68%	4	2.51%	17	41
6	Riverside-San Bernardino	CA	91.42	11	2.22%	11	83.2	9	2.02%	15	2.98%	7	53
7	Seattle	WA	105.61	8	1.93%	13	68.5	13	1.67%	18	3.31%	2	54
8	San Antonio	TX	73.66	15	2.76%	1	53.3	18	2.39%	8	2.49%	20	62
9	Orlando	FL	90.30	12	2.62%	5	75.2	11	3.07%	3	1.89%	32	63
10	Fort Lauderdale	FL	59.17	19	2.41%	7	57.7	16	2.51%	6	2.52%	16	64
11	Tampa-St. Petersburg	FL	76.10	14	1.89%	14	72.3	12	2.02%	14	2.82%	11	65
12	Washington DC	DC	104.53	9	1.39%	22	77.6	10	1.57%	20	2.58%	15	76
13	Sacramento	CA	49.23	24	1.75%	15	49.9	20	2.04%	13	3.18%	5	77
14	Chicago	IL	141.20	6	1.01%	31	88.6	7	0.84%	30	2.93%	8	82
15	West Palm Beach	FL	41.91	28	2.31%	8	45.3	23	2.67%	5	2.50%	19	83
16	Minneapolis-St. Paul	MN	90.24	13	1.63%	18	55.7	17	1.45%	22	2.59%	14	84
17	New York-No. New Jersey	NY	298.24	1	1.15%	27	151.9	1	0.73%	32	2.28%	25	86
18	Denver	CO	61.34	18	1.60%	19	49.5	21	1.64%	19	2.88%	10	87
19	Charlotte	NC	56.46	21	2.14%	12	48.3	22	2.39%	7	2.11%	30	92
20	Raleigh	NC	41.58	30	2.65%	4	41.2	24	3.15%	1	1.84%	34	93
21	New York-White Plains	NY	178.88	4	1.13%	29	84.0	8	0.64%	33	2.38%	23	97
22	Santa Ana (Orange County)	CA	71.35	16	1.54%	20	39.8	25	1.32%	23	2.62%	13	97
23	Portland	OR	53.54	23	1.67%	16	58.2	15	2.19%	12	1.87%	33	99
24	Los Angeles	CA	104.49	10	0.83%	33	122.2	5	1.21%	24	2.12%	29	101
25	Baltimore	MD	47.84	25	1.19%	26	28.9	29	0.92%	29	3.16%	6	115
26	Nashville	TN	35.21	32	1.51%	21	26.1	30	1.46%	21	2.71%	12	116
27	Miami	FL	41.78	29	1.31%	24	50.3	19	1.94%	16	2.01%	31	119
28	San Diego	CA	53.84	22	1.34%	23	32.8	27	1.04%	27	2.43%	22	121
29	Oxnard-Ventura	CA	15.11	35	1.64%	17	14.0	35	1.72%	17	2.25%	26	130
30	Oakland	CA	38.50	31	1.20%	25	30.4	28	1.09%	26	2.46%	21	131
31	Boston	MA	58.80	20	0.80%	34	38.1	26	0.73%	31	2.23%	27	138
32	San Jose	CA	31.46	34	1.13%	30	22.6	31	1.21%	25	2.50%	18	138
33	San Francisco	CA	34.79	33	1.15%	28	20.9	33	1.01%	28	2.36%	24	146
34	St. Louis	MO	42.16	27	1.00%	32	21.0	32	0.63%	34	2.18%	28	153
35	Philadelphia	PA	42.43	26	0.73%	35	16.2	34	0.36%	35	1.80%	35	165
	<b>US</b>		<b>5,501.82</b>		<b>1.30%</b>		<b>4,559.9</b>		<b>1.27%</b>		<b>2.70%</b>		

Source: Economy.com, Census Bureau, Bureau of Labor Statistics and RREEF Research

### General Risks to the Strategy

As public home builders have unloaded land positions in 2007 and 2008 to appease shareholders and generate cash flow, some healthy private builders, investment groups and developers are bargain shopping. As noted earlier, some public builders are contracting with third parties to maintain a stake in their land for future use. Many residential land owners face new market realities and are beginning to concede the value of their property. Property & Portfolio Research (PPR) noted that even though there have been sharp declines in value, the perception is that values are still inflated and that this concern may be justified. PPR cited land researchers Morris Davis and Jonathan Healthcote, "Since 1975 the land portion of the average US home property has risen in value from 37% to 46%, or nearly half of the home price." Also noted is the 65% increase in the brick-and-mortar value of homes rose compared to the 142% increase of the land on which they are built.

Determining the appropriate value of land is a specialized strategy and several risks can derail an investment. A few are noted below:

Interest rates – housing is highly correlated with changes in interest rates; consider the negative impacts of higher interest rates on mortgage rates and demand for new home sales.

Economic change – fewer jobs and higher unemployment rates could lead to a decline in consumer confidence, household formations and ultimately slow consumer demand for new home sales.

Regulatory/public policy – examples include a change in lending and mortgage underwriting tightening requirements for mortgage applicants reduces the pool of potential buyers; also, proposed legislation granting tax credits to buyers of foreclosed homes may reduce the pool of potential new home buyers as well.

Real estate risk – supply of existing inventory, permits and starts must be monitored regularly. Excess supply and changes in national regional or local economies could adversely impact the valuation of land parcels necessitating write-downs to market value.

## Appendix A

### Selected Current Homebuilder Joint Ventures

**LandSource:** The three major equity partners include Lennar, LNR Property and, most recently admitted, MW Housing Partners (MWHP, which includes MacFarlane Partners and CalPERS). Further, ... "MWHP contributed cash and approximately 4,000 home sites totaling nearly \$970 million to LandSource in exchange for a 68% interest in LandSource. The Company and LNR will each retain a 16% interest in LandSource. The home sites, which are part of an existing land bank relationship between MWHP and the Company, were contributed at current market value. The Company will retain a promote opportunity allowing it to have a disproportionate share of LandSource's future positive net cash flow. The Company also retained options and rights of first offer to purchase property currently owned by The Newhall Land & Farming Company, LandSource's primary investment. The transaction resulted in a cash distribution of approximately \$700 million to the Company. As part of the transaction, LandSource completed a new \$1.55 billion bank debt financing."<sup>8</sup> As a sidenote, they just defaulted on this debt.

LandSource Communities Development LLC engages in the development of residential, industrial, and commercial real estate, as well as in agriculture, on approximately 48,000 acres in California. Its primary business is developing new towns and master-planned communities, Valencia and Newhall Ranch, which are located on the company's prime landholding consisting of approximately 18,000 contiguous acres in north Los Angeles County, California. LandSource Communities Development LLC sells residential lots to merchant builders; operates a portfolio of commercial properties; provides building-ready sites for sale to industrial and commercial developers/users; and owns a public water utility, Valencia Water Company. The company's agricultural division consists of farming and energy operations. LandSource Communities Development LLC operates as a subsidiary of MacFarlane Partners, LLC.

**Kyle Acquisitions:** Lehman Brothers reports that the primary members include Lennar, Toll Brothers, Pulte, Ryland, Meritage, KB Homes, and Beazer Homes and that the land is in Las Vegas. This JV appears to be in trouble as noted in Standard & Poor's commentary that they were in default.<sup>9</sup> Disclosure by builders varies with regard to off-balance sheet obligations; information was relatively scarce.

The joint venture debt outstanding for LandSource and Kyle is estimated at \$1.3 billion and \$500-\$700 million, respectively, and is non-recourse.

**Inspirada:** Major partners in this 2,000-acre Las Vegas development include Toll Brothers, KB Home, Kimball Hill Homes, Beazer Homes and several others. The development ultimately was planned to yield 13,500 new homes. Toll Brothers filed documentation in its quarterly financial statement with the Securities and Exchange Commission that warned of "significant losses" if JV partners do not honor obligations during the slowdown in the housing market. Toll did not specify any companies by name, but one of the JV partners is Kimball Hill Homes, which is currently restructuring itself and has stated it is contemplating a bankruptcy filing. Another partner is Las Vegas-based master developer Focus Property Group, which reportedly stopped paying interest on its outstanding loans last month and announced that it had retained the financial advisory services of The Blackstone Group. Focus CEO John Ritter

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<sup>8</sup> Lennar SEC filing 2007.

<sup>9</sup> Leveraged Commentary & Data, March 6, 2008, Standard & Poor's.

says the company is making an effort to restructure its debt and to obtain new capital for liquidity and operations during the downturn.<sup>10</sup>

Pulte, Ryland, Lennar and Kimball Hill Homes and others are involved in another JV in the Vegas metro area that is just as large as Inspirada. The Kyle Canyon JV is embroiled in an auction of federal land to a consortium. Lead by Focus, the JV involved 1,710 acres of raw land at the height-of-the-market in 2005. The deal was secured with a \$510-million bid, or nearly \$300,000 an acre, which reportedly represents a 10-fold increase over the price of land secured by Del Webb just five years earlier in the same proximity. According to a filing with the SEC, Kimball Hill is committed to take down another \$59 million in land by this May.<sup>11</sup>

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<sup>10</sup> Corkery, M. "Toll Warns of Risks Tied to Ventures", March 11, 2008, The Wall Street Journal.

<sup>11</sup> Marquis-Jackson, L., Big Builder News, March 13, 2008.

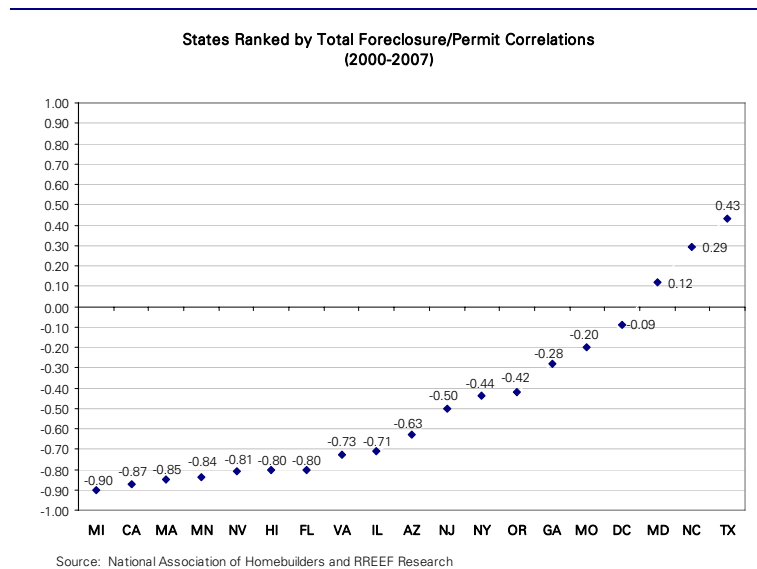
# Appendix B

## Empirical Evidence

Today's housing market is not only characterized by over-supply, but also demand side issues that triggered mounting foreclosures. These factors include falling house prices, unaffordable mortgages and higher rates of unemployment and have created a ripple effect of reinforcing market distress and severely restricted mortgage availability. As a recently published study by the National Association of Homebuilders (NAHB) study noted, "falling house prices will also chill new production as builders attempt to reprice existing inventory and find ways to reduce costs and compete at lower price points."<sup>12</sup>

A key question to ask when considering the time to execute a land strategy is at what point in the housing cycle will builders start to build again? One perspective is to look at the relationship between foreclosures, production and home prices and whether they move in any predictable pattern. Calculating simple correlation coefficients is one measure of the strength of the variables' relationship to one another. A recently published study by the National Association of Homebuilders (NAHB) evaluated these variables and found the most powerful relationship existed between the foreclosure start rate (the percentage of loans entering the foreclosure process during a given period) and single family permits. The relationship is negative; when foreclosures rise, single family permits decline.<sup>13</sup> This is fairly intuitive as the housing market must work through the inventory of foreclosed homes, which are offered at a highly discounted price, and temporarily distort the market value of home prices and compete with new construction for customers. This dynamic makes it much less profitable for builders to start building and holds down permit issuance. The study stops short of a forecast for a resumption of home building; however, one can infer this will occur when the bulk of foreclosures have cleared the market and prices have stabilized.

A sampling of states and the correlations of foreclosures to single family permits for the period 2000 to 2007 is noted in the chart below.<sup>14</sup>



<sup>12</sup> Emrath, Paul, Ph.D., "Foreclosures, Production, Prices and Homeownership by State", Housing Economics, April 2008, National Association of Homebuilders.

<sup>13</sup> Emrath, 2008.

The relationship is strong and relatively persistent, but varies widely among the states. The negative relationship is strongest in Michigan, California, Massachusetts, Minnesota, Nevada and Florida where, not surprisingly, problems in the housing markets have been more severe. Presumably, in these markets in particular, the level of foreclosures would have to tail off and at least stabilize before builders would begin pulling permits again.

The relationship is less straightforward for those markets less negatively correlated or even less positively correlated. Differences in the level of distress and the timing of the market cycle in individual markets could account for the disparities.

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<sup>14</sup> When the correlation between two variables is positive, they tend to move up or down together. When negative, it means when one rises, the other declines; therefore, a coefficient of 1 means that two variables are "perfectly" correlated.

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