

CONTRARIAN HOLDINGS



The Case for Land
2006

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Written by Randy Samelson
Contrarian Investors, LLC

2 N. Cascade Avenue Suite 590

Colorado Springs, CO 80903

719-540-5800

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THE CASE FOR LAND – Executive Summary

We have previously written about why we believe conventional investments may underperform investor expectations for an extended period of time. Consequently, we have been alert for special situations in which superior returns can be achieved. In November 2004, we started the series *The Case for Silver* (available upon request). At that time, silver was selling for \$6 per ounce and has subsequently risen to as high as \$15 per ounce. We now believe it is time to prepare for a potential “once-in-a generation,” post-mania land price collapse.

After the stock market bubble burst in 2000, deflation loomed with debt littering the national and consumer landscape. The Federal Reserve Board was intent upon avoiding a repeat of the 1930s in the U.S. and the 1990s in Japan. Thus, they drove interest rates to the lowest level since the 1950s. Not surprisingly, all this did was transfer risky behavior from stocks to the highly leveraged world of real estate. Lenders, happy to oblige the real estate stampede, responded with risky financing vehicle after risky financing vehicle. Real estate demand soared, and prices bubbled. Today, in our opinion, it is not a matter of “if,” but “when,” excessive risk taking in real estate, and specifically land, will be punished. The implications compelled us to write *The Case for Land*.

The Typical Housing Cycle and Its Correlation to Land Prices

Homebuilding is a cyclical industry. There are periods when levels of new home construction and prices increase. Likewise, there are periods when levels of new home construction decrease, and prices stabilize or fall. The cycle tends to be national in scope, but the degrees of change are localized.

There are few homeowners who have not experienced the difference between a buyers’ market and a sellers’ market. In a buyers’ market, “for sale” signs abound, and sellers are eager for almost any offer. Conversely, there are sellers’ markets where offers stream in, often above and beyond the asking price. What is not commonly understood by most homeowners is the implication this has on land prices.

Land prices and the housing cycle are correlated. During increasing levels of home building, land prices increase due to higher demand. In order to supply needed homes, homebuilders drive up prices by buying and accumulating huge amounts of urban or population pressured land. On the other hand, during decreasing levels of home building, land prices decrease as demand decreases. Homebuilders not only buy much less land, but they often try to sell off excess land inventories acquired during expansion.

Importantly for our discussion, we believe the current housing cycle is atypical. Its growth is magnified beyond rational supply and demand levels. More importantly, its decline might be magnified as well. As a result, the implications upon land prices could be severe.

Portrait of a Mania

Occasionally, conditions converge that cause the housing cycle to exaggerate and develop into a bubble followed by a bust. We believe the current housing environment is such a situation -- a housing cycle that has outgrown typical behavior and has irrationally expanded into a maniacal, speculative bubble. Moreover, we believe that the bubble has already burst.

The only remaining issue is whether the result will be a soft or hard landing. A soft landing could result in a somewhat orderly decline in home and land prices. A hard landing could result in crisis. We are preparing for the possibility of a hard landing based upon the following observations and beliefs:

Low interest rates induce a speculative housing bubble

Low interest rates generally induce risky behavior. The more leverage available and the more unsophisticated the user, the greater the implication of the risky behavior. Recent risk taking during a period of historically low interest rates resulted in a housing bubble with two dimensions – a sales bubble and a price bubble.

First, we will address the sales bubble. From 1991 to 1999, the upswing of the housing market cycle was fairly typical of previous cycles although slightly amplified. During this time, broad fundamental economic and population growth supported the sale of new homes.

However, in 2001, something changed. Instead of a typical cyclical correction, the level of home sales suddenly spiked and reached dizzying heights by 2005.



The reason for the spike was simple. After the 2000 crash in technology stocks, the Federal Reserve panicked and reduced short-term interest rates to levels not seen in sixty years. Lower interest rates resulted in lower mortgage payments and increased buying power. The buyer pool increased as people who previously could not qualify for a mortgage now could.

In addition, speculators, turned-off by the stock market and looking for profits elsewhere, entered the market and further increased home sales. They often used extensive leverage to buy several houses at a time. Generally, these houses were purchased with no intent to occupy, but only with the intent to flip for profit. According to the National Association of Realtors, forty percent of all homes purchased in

2005 were for second home (28%) or investment (12%) purposes, both forms of speculation. As a result, home sales hit records that were not remotely justified by the fundamentals.

Second, as interest rates fueled sales, a price bubble also emerged. Because the number of people willing and able to pay for property increased, housing prices appreciated rapidly. Eventually, so many people were pursuing houses in hot markets that bidding wars became commonplace. Home values soared at unbelievable and unsustainable clips. For instance, the median price of a house in Phoenix grew by 48.9% in 2005 alone. During the same time, homes in Cape Coral and Ft. Meyers, Florida experienced 48% appreciation.

Speculative bubble creates homebuilder demand for land

Homebuilders benefited greatly from the home sales and price appreciation bubbles. These benefits included huge homebuilder profits and soaring stock prices. The following chart describes the Philadelphia Housing Sector index:



Armed with these immense profits and stock price windfalls, homebuilders began acting as a herd. They scoured many metropolitan areas (and beyond) for land in anticipation of continuing record home sales

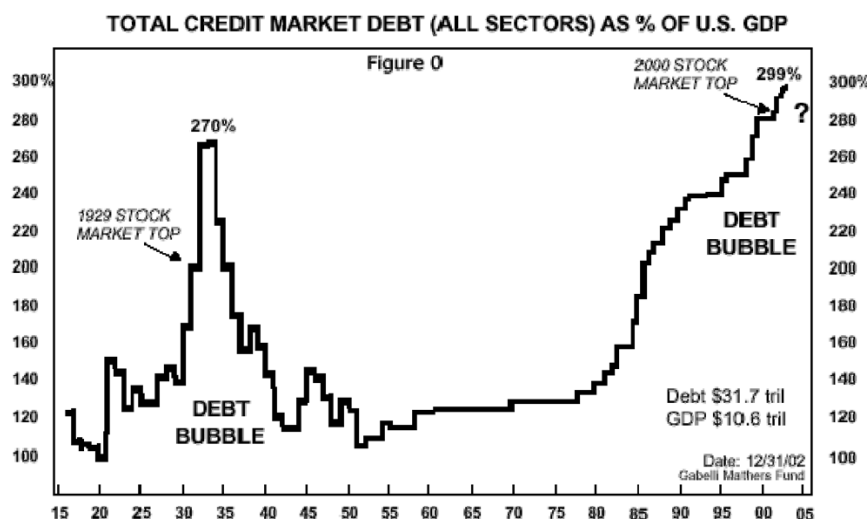
and price appreciation. As a result, the homebuilders accumulated an enormous supply of land. Not surprisingly, this demand caused land prices to soar.

In October 2005, the *Wall Street Journal* reported that national builders such as K. Hovnanian controlled land for more than 100,000 houses while Pulte Homes held land for roughly 350,000 homes. Still, others like Lennar, Centex Homes, D. R. Horton, and KB Home controlled land for hundreds of thousands more. Even though land inventories represented as much as a ten-year supply for some, homebuilders continued a ferocious pursuit for new ground.

Consumer debt and rising interest rates imperils homebuilders

The implications of a housing bubble coupled with homebuilders' huge land inventory are exacerbated by American consumer indebtedness. National consumer debt is at an alarming level. Savings rates are negative for the first time since the Great Depression.

The following graph demonstrates the increased presence of debt in the economy:



Compounding the fragile debt situation is a new reliance on adjustable rate mortgages (ARMs). ARMs provide millions of Americans the ability to buy/finance houses with little or no money down.

According to First American Real Estate Solutions, 7.7 million borrowers took out \$1.88 trillion in ARMs between 2004 and 2005.

However, while the huge amount of debt is significant on its own, the improper reliance on ARMs can trigger a crisis when interest rates rise. Unfortunately, that's exactly what has been happening. In recent years, the Federal Reserve, reacting to the risky behavior in many asset classes, particularly in housing, began to raise interest rates. Since June 2004, the Federal Reserve has hiked interest rates seventeen times.

Interest rates have a delayed effect on real estate markets. Like a large ship, the housing market took time to turn. However, the consequences of the hikes are finally being realized. Appreciation has slowed or decreased in many markets. Accordingly, in the second quarter of 2006, 59 out of 151 surveyed markets experienced housing price declines from their highs set within the previous three quarters.

Unfortunately, rising interest rates and falling home prices can destroy those who rely on ARMs. When the ARMs readjust at higher rates, many of those consumers will face double or even triple monthly payment increases. For the average borrower who was struggling to qualify for a mortgage, that increase can be overwhelming. It is not surprising that the rate of home foreclosures is rising rapidly.

Imperiled homebuilders suggest motivated sellers ahead

As home sales slow, existing inventory will increase or even soar. According to CNBC, in Phoenix, the number of unsold homes increased tenfold from 4,500 to 45,000 in just the four months from January to April 2006. Likewise, Miami, once the epicenter of the condo-flipping craze, is now the poster child for the dangers of speculation as its skyline is checkered with vacant residential high-rises. Still, other hot markets like Las Vegas, Southern California, and Virginia, have cooled considerably with sellers outnumbering buyers and homebuilders offering generous incentives to move new homes. By necessity, homebuilders will stop purchasing land, resulting in the removal of the dominant source of buyers from the market.

Moreover, as the residential housing outlook has deteriorated, homebuilder stocks have collapsed.

Notice the drop in the Philadelphia Housing Sector index from mid 2005 to August 2006 on the chart below:



In response to soaring existing home inventories and falling stock prices, homebuilders will seek to reduce liabilities and generate cash. A likely method to achieve this goal will be the forced selling of much of their huge land inventories.

Motivated sellers suggest a land price collapse

Land prices stop rising when demand for housing decreases and sellers begin to exceed buyers.

Ultimately, land prices collapse when motivated sellers, who need to reduce debt or hope to sell before prices fall further, become highly motivated or even panicked sellers.

In the land business, there are at least two principal types of motivated sellers. First are homebuilders who respond to the deteriorating conditions of their industry. The second are land speculators who buy and “flip” or develop residential land to sell to homebuilders for quick profits. As homebuilders begin to reduce land purchases and/or drop options to buy land, land speculators are often left holding land they have no intention or desire to hold. They then can become highly motivated.

Motivated selling by homebuilders and land speculators can lead to a land price collapse and an opportunity for the astute investor.

Investment Rationale

The possibility of a land bust is particularly exciting to us, because land is one of our favorite asset classes. There are six reasons why we like it:

1. Volatility creates opportunity

The price of land is volatile and, in fact, is prone to booms and busts, depending upon demand for its ultimate use. For contrarians, booms (especially bubbles) provide selling opportunities while busts provide buying opportunities. There are periods, including 9 recently, when the demand for housing is high and lenders provide multiple layers of debt. Debt in real estate magnifies price swings. During bust periods, land speculators struggle to pay these debts, and lenders foreclose. These periods of stress create opportunities for contrarians.

2. Supply and demand is favorable

Population growth creates continuous demand. Yet, supply is limited; as Will Rogers said, “Land...they ain’t making any more of it.”

Demand can swing wildly for real estate and land. There are periods of high demand when homebuilders, real estate speculators, and home buyers rush into real estate. Conversely, there are periods of low demand when the impact of leverage or need for liquidity prompts aggressive selling. However, in both environments, the supply of land shrinks due to population growth pressures. Therefore, when demand is low and motivated sellers dominate, significant opportunities can be created.

3. Long holding periods are valuable

A well-timed purchase of a great land parcel permits very long holding periods. When purchasing land, we plan to own it for 10 or even 20 years so we can maximize the opportunity rather than take profits too quickly. We are eager to make these long-term land investments and believe they create at least two valuable benefits.

- One benefit is improved decision making. Today's culture and investment world is characterized by hyperactivity. Evidence includes the proliferation of day trading, mutual fund switching, and individual stocks collapsing due to narrowly missed quarterly earnings. Hyperactivity leads to a greater risk of poor decisions. In our opinion, infrequent, deliberate, well-planned decisions increase the likelihood of wise choices and provide the tranquility necessary to identify major moments of over or under valuation. Warren Buffett suggests that the quality of decision-making could be dramatically improved if investors were restricted to only 20 decisions per investing 10 career. Buffett gives the example of a baseball batter just patiently waiting as the pitches sail by him. You wait for the perfect pitch -- and then you hit it out of the park.

- The second benefit of long holding periods is tax and transaction efficient compounding returns. The benefits are described by Buffett biographer Robert Hagstrom in the following example: "Start with a \$1 investment that doubles in value every year. From there you have two options: (1) Sell the investment at the end of the year, pay the tax, and reinvest the net proceeds. Do the same thing every year for 20 years. End up with \$25,200 clear profit. (2) Don't sell anything. At the end of 20 years, end up with \$692,000 after-tax profit." Need we say more?

4. Few competitors

Since patient capital for land acquisition is rare and our investment timeframe is longer than typical buyers of land, we tend to have few competitors. Thus, the competitive pool of buyers is shallow.

Homebuilders and developers, who buy the majority of urban pressured parcels, are impeded from our long-term “land banking” due to shareholder or debt demands. This suits us, because we certainly do not want to compete with them for land purchases (although we are happy to sell to them when their wallets are bulging!).

Because we have limited competition, we also have bargaining power with sellers. We are often able to negotiate favorable deals.

5. Diversification

Land provides diversification. Most investors’ portfolios consist of stocks and bonds and mutual funds that own them. Opportunities to share in the benefits of land ownership are limited.

Diversification is a commonly accepted tenet of investing; yet we believe, and do so strongly, that it is unattainable without exposure to alternative investments. The vast majority of investors have been convinced that diversification is achievable with stocks and bonds. Unfortunately, and irrefutably, long periods of history do not bear this out.

From 1968 to 1982, beyond the memories of most investors (and excluded in most Wall Street performance presentations), both stocks and bonds dropped. Similarly, from 1982 to 2000, stock prices rose dramatically while the return from owning bonds was even better. Despite almost half a century of correlating movement between stocks and bonds, misperception stubbornly maintains a stronghold that someone can diversify by using stocks and bonds.

The bottom line is broader asset class exposure is a plus. Limiting a portfolio to stocks and bonds is not diversification. True diversification comes from an ability and willingness to understand and exploit

investment opportunities over a broad spectrum of asset classes. In our opinion, land provides a great alternative asset.

6. Cash flow

Some types of land have cash flow or potential cash flow from basic resource production (i.e. corn, sand and gravel, water). Often this cash flow produces favorable yields during holding periods or, at least, helps cover holding costs.

Investment Strategy

The strategy we have used in the past is simple. It involves four steps:

1. Buy well-located land at bargain prices when fear is rampant.

We seek land in the path of future population pressure. There are counties, states, and regions whose populations are growing or are likely to grow rapidly. Conversely, there are counties, states, and regions whose populations are likely to remain relatively stagnant. We are most interested in looking where the former is true.

We seek a highly motivated/distressed seller for an individual parcel (and preferably for the real estate asset class in general). The right purchase price can overcome a multitude of post-decision mistakes and missteps. The best investment opportunities are characterized by substantial price drops within a given asset class. Vacant land opportunities are often created by overbuilding, economic recessions, or rising interest rates. Agricultural land opportunities frequently arise after several years of natural disasters or when depressed commodity prices have led to a decline in farm income. Foreclosures, bankruptcies, and selling by banks, farm credit services, insurance companies, etc. are strong indications of contrarian opportunities.

Famous investor Sir John Templeton said, “You should resist the temptation to invest in any asset which could have produced the best performance the previous five years. Instead, search worldwide for some type of asset which could have produced the worst performance for the past five years and then select from that list those whose depressed price were caused not by a permanent, but by temporary influences.” We agree.

Finally, we seek a purchase price that is less than a willing buyer and seller had previously agreed to or is significantly below prior market value. In other words, we would prefer to buy somebody else’s mistake and then allow a future economic cycle and future population pressure to trigger a price recovery that equals or exceeds the prior higher price.

2. Add value

Identifying the “highest and best” use for the acquired land can lead to actions that may increase entitlements for property. Annexation, up-zoning, and obtaining development plans are examples of methods to add value.

3. Recover the initial investment

As property values increase due to value-added activities and/or improvements in market conditions, a variety of techniques can be employed to recover the initial investment. One option is to refinance the property with equity or debt capital. Alternatively, certain small parcels can be sold as population growth creates demand or prices recover. The objective at this stage is to raise new capital or sell sufficient property while maintaining a significant ownership in the most strategically located parcels.

4. Sell high when greed is pervasive

Eventually, if local conditions lead to dramatic rises in land values, we will seek to sell or alternatively retain an ownership in certain income producing vertical improvements by entering into land leases and/or joint ventures with “free and clear” land.

Conclusion

One reliable element of investing is that all asset classes move in broad cycles from greed to fear and back again. They move from periods of massive hype with broad public participation to periods of disdain with only professional accumulation.

Occasionally, asset classes move beyond broad cycles to manias and bubbles. In these environments, euphoric buyers drive prices to irrational levels, which are followed by plummeting prices spurred by panic selling. It is during these unusual periods that contrarian investors have an extraordinary opportunity.

Today, we believe that land (one of our favorite asset classes) has experienced a speculative bubble. As a result, we believe land is poised for a price collapse. If it does, a once-in-a-generation buying opportunity for land could occur. As contrarian investors, we will be prepared.