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Understanding land-secured municipal bonds

INSIGHTS FROM NUVEEN'S MUNICIPAL RESEARCH TEAM

Land-secured municipal bonds primarily finance basic public infrastructure projects such as roads, water and sewage lines, lighting, traffic lights and other essential components of real estate development. This financing tool generally supplements the overall capital funding plan of a development project. These bonds are referred to as "land-secured" because the obligation to pay taxes and assessments that ultimately pay debt service on the bonds typically attaches to the land itself.

LAND-SECURED BONDS HAVE SPECIFIC FINANCING STRUCTURES

Land-secured bonds are usually issued through special taxing districts, which are independent governmental units that exist with varying degrees of administrative and fiscal independence from local governments.

The laws governing the structure and sale of land-secured bonds differ by state. However, the structures, debt security features and issuance procedures share many similarities. Fundamentally, a land-secured bond works like this:

- Within the taxing district, a tax lien is placed on property benefiting from the public infrastructure constructed with proceeds from the bond issue. This lien is paid off over time via periodic assessments or taxes.
- The revenues generated from the special assessments or taxes are used to pay debt service on the bonds. The tax or assessment lien is senior to any mortgage on the property.

The basic types of land-secured municipal bond structures include:

Special tax districts. Bonds are secured and payable by a tax levied annually on the property within the district. The amount of the tax levied on property owners to help pay for the debt service must be reasonable, but may change based on higher or lower project costs, tax collections and other variables.

Special assessment districts. Bonds are secured by a special assessment lien on property within the district. The amount of each assessment lien is based on mathematical formulas that consider how much each property will benefit from the infrastructure improvement funded by the bonds. The assessment lien is usually a fixed amount.

Limited tax districts. Bonds are secured and paid from an annual limited ad valorem tax levied within the district. The amount of the tax lien is determined by the amount of reimbursable public infrastructure costs within the district, along with underwriting standards that evidence the district's ability to pay debt service as vertical development occurs. The tax rate is capped at a not-to-exceed tax rate, meaning the assessed value of the district must reach a certain level in order for the district to generate sufficient revenues to pay debt service.

SECTOR STATUS IS MIXED

While land-secured bonds are generally viewed as a higher-risk sector at issuance, these risks may decline as additional vertical development occurs and taxpayer diversity increases.

Sector risks

Development risk. Until fully built-out, all land-secured bonds bear some degree of development risk. In troubled real estate markets, projects can struggle and may be abandoned by developers and homebuilders, potentially leading to defaults in certain issues.

Potentially high leverage. Some bonds may come with high leverage, such as a value-to-lien ratio of only 2:1 at issuance. This means that the appraised value of the land in the district was valued at two times the amount of land-secured debt issued. In certain cases, especially where a portion of the property securing the bonds remains undeveloped, the value of the undeveloped property may fall below the amount of the land-secured debt allocated to that property. In these situations, the property owner or other interested party (such as the bank lender) is not economically motivated to pay their special tax obligations.

Taxpayer concentration. A land-secured municipal bond can mean that investors have long-term exposure to a single developer or group of developers. This characteristic is lengthened when project development slows.

Sector strengths

Projects with significant absorption. In many cases, the real estate development benefiting from the bond-financed infrastructure is either complete or substantially complete. These bond issues generally feature diversified tax bases that reduce the risk of large-scale delinquencies, as well as strong collateral coverage given the degree of completion of improvements and construction. Bonds with these characteristics are generally viewed as investment grade quality.

Potential credit improvement. Land-secured bonds typically come nonrated at the time of bond issuance due in large part to the risks noted above. However, these risks may decline over time as vertical development occurs and property ownership within the district diversifies. Once the tax or assessment burden shifts from a concentrated taxpayer base to a more diverse ownership base, such bonds can garner an investment grade rating.

CALIFORNIA: REMAINING RELATIVELY STABLE

The land-secured municipal bond market in California has remained relatively stable over the past decade. According to Bloomberg, the state currently has $10.7 billion in land-secured bonds outstanding, with only 3.0% classified as distressed.

The vast majority of land-secured bonds in California are issued by special tax districts known as Community Facilities Districts, or CFDs, pursuant to the Mello-Roos Community Facilities Act of 1982. Due to the long history of this financing mechanism and the relatively strict underwriting requirements, CFD bonds issued in California have historically experienced minimal distress as compared with structures in other states. A key strength of the CFD structure in California is the 3:1

value-to-lien requirement on all new bonds, which stipulates that the appraised value of all property within the specific CFD meets or exceeds the attached debt by at least three times.

Throughout 2023, land-secured municipal bond issuance in California was good, with aggregate issuance across the state of roughly $2.1 billion. This is up approximately $200 million year-over-year, and up significantly from the $1.4 billion during 2021, which matched the record year set in 2015.

Moving into 2024, California's housing market remains competitive as demand for single-family homes continues to outpace the supply of newly constructed homes, contributing to increasing housing costs. In May, the median price for a single-family home in California rose to an all-time high of $908,000, an 8.7% year-over-year increase with a 48.6% increase demonstrated over the past five years. Given the persistent housing shortage in the state, Governor Newsom recently signed into law various measures to remove some constraints and barriers to constructing new affordable housing. Homebuilders are expected to continue to capitalize on these dynamics to narrow the gap between the ever-increasing demand for affordable single-family homes and the shortage of existing homes.

The continued strength of California's economy and the limited supply of developable land in the state's more coastal locations has led to a significant increase in homebuilding activity throughout the more inland communities in recent years. Large-scale projects such as "The Great Park" in Irvine and "Westpark" in Roseville continue to be met with strong demand. Furthermore, land developers are continuing to work with state and local governments to alleviate California's housing affordability crisis by sourcing opportunities in many of California's less populated areas, such as those located in the Central Valley.

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COLORADO: GROWTH SLOWING, YET STEADY

Most land-secured bonds in Colorado are issued through special taxing districts called Metropolitan Districts (MDs) and are usually paid from a limited ad valorem tax pledge levied within the district. Most districts consist of residential communities, so their credit quality - especially that of districts in the early development stage - is highly correlated with the strength of the housing market. This is because new home construction and valuation establishes the tax base in the district to support the repayment of the bonds.

The housing market, both nationally and within Colorado, experienced strong price appreciation over the past several years until facing recent volatility. The S&P CoreLogic Case-Shiller CO-Denver Home Price Index increased 68% from May 2018 until reaching its peak in May 2022. Subsequently, prices declined 10% from May 2022 through January 2023 - reflecting increases in mortgage rates and a softening economy - before rebounding and increasing 6% from January 2023 through April 2024. The national index trended relatively similarly over the same time periods.

Land-secured issuance in the state increased significantly in recent years but declined in 2023 and year to date in 2024. Total new issue volume grew from less than $100 million annually post the Great Recession to more than $1 billion in 2018, a record high $2 billion in 2021, and $1.7 billion in 2022. However, issuance dropped to $558 million in MD bonds issued in 2023 and $314 million issued year to date (through June) in 2024. The decline is largely due to higher interest rates causing issuers to delay bond issues. We expect issuance to pick up in the second half of 2024, particularly if rates decline.

Ongoing population growth, particularly along the Front Range, is the main driver of home construction and supports the credit quality of MD bonds. From 2010 to 2023, the state's population increased by 16% (1.3% annually), ranking Colorado as the eighteenth fastest state in growth rate over this period. While the population growth rate is slowing with an average annual growth of 0.63% for the five-year period through 2023, Colorado continues to rank in the top ten in numeric population growth, ranking 9th from 2022 to 2023.

Overall, favorable demographic trends support the Colorado housing market and the credit quality of Colorado land-secured credits. The biggest concern surrounds affordability and high mortgage rates. The increase in mortgage rates over the past 24 months has brought some uncertainty to the housing market, as evidenced by some volatility in home prices during this period. But recent trends appear positive, as the number of single-family permits issued year to date nationwide increased 25% year-over-year.

Further, existing home sales remain low versus historical averages, as homeowners with low interest mortgages are reluctant to move. This has pushed buyers into the new home market, thereby supporting the credit quality of MD bonds, particularly those in the early development stage.

FLORIDA: PRIMED FOR CONTINUED GROWTH

Land-secured bonds in Florida are known as Community Development Districts (CDDs) and are secured by an annual assessment levy upon each planned lot/land parcel through maturity of the bonds. From 2019 to 2023, aggregate new money volume in Florida CDD bonds totaled more than $5.6 billion, with 2023 topping a record $1.5 billion. Total volume (i.e., new money and refinancing) during 2023 exceeded $1 billion for an eighth consecutive year.

This resurgence in new issuance has been driven by the continued recovery in the Florida housing market since the downturn of 2008 to 2011 and the ongoing demand from the homebuilder community to source developed residential lots. They remain thirsty for new land opportunities given the continued in-migration and high-income job growth within the state. According to John Burns Research & Consulting, homebuilders within the state of Florida plan to increase actively selling communities by 17% in 2024, which far exceeds expectations at the national level of 11%.

An outsized percentage of new issuance over the past several years has originated around the broader Tampa area in the counties of Hillsborough, Manatee, Pasco and Polk. Since the end of the housing crisis in 2011, more than 350 individual bond deals have originated from these four counties alone, representing more than 40% of the state's land-secured issuance. A recent market update by MetroStudy showed first quarter 2024 home closings throughout Tampa were up 18% year-over-year, reflecting continued healthy buyer demand. Three cities within the broader MSA ranked in the top 20 nationally for population growth during 2023, including Lakeland, Tampa and Sarasota.

However, the area housing market may be cooling, with prices beginning to drop and homes taking longer to sell following several years of a scorching market.

Over the past 18 months since early 2023, prospective homebuyers have focused on the new home market given the lack of resale inventory, as many existing homeowners are reluctant to list their homes in the current rate environment. Despite elevated mortgage rates, homebuilders are benefiting by actively using incentives to improve affordability, including base price reductions and buying down mortgage rates. Given their healthy balance sheets and better wherewithal to adjust pricing and offer incentives, we anticipate homebuilding entities to continue taking market share over the intermediate term. As has been witnessed recently, this should benefit construction/sales velocity within master-planned residential communities in which we maintain exposure. According to RCLCO, 16 of the nation's top 50 master-planned communities in 2023 were in Florida.

TEXAS: BENEFITING FROM POPULATION GROWTH

Texas land-secured bonds are known as Public Improvement Districts or PIDs and are secured by an annual assessment levied upon each planned lot/land parcel through the maturity of the bonds. The Texas PID market is a relatively new and growing segment of the municipal land-secured sector. Bonds issued totaled more than $1.96 billion over the last five years and $457.5 million in 2023. So far in 2024, there have been 24 issuances for $209 million. We expect this market to continue to expand due to population growth in Texas.

The vast majority of issuance in 2023 and over the last five years has occurred in and around the Dallas-Fort Worth Megaplex. The DFW area accounted for 80% of issuance in 2023 and 72% over the last five years. We are seeing more issuance from the Austin area, which accounted for 19% of issuance in 2023 and 23% over the last five years. The Houston area and San Antonio are expected to become larger market participants over the coming years.

Strong population growth in Texas has been the primary driver behind the strong local real estate markets. Given the limited resale inventory, the new home market continues to benefit from strong demand. Homebuilders use incentives such as upgrades and mortgage rate buy downs to improve affordability and increase demand.

Nuveen is watching housing inventory levels, available supply and vacant developed lots. Active housing inventory for sale in the DFW area is at its highest point since the pandemic but remains slightly below 2019 levels. The Case-Shiller Dallas Home Price NSA Index is up 3.4% over the last year, 9.6% over the last three years, and 8.1% over the last 10 years. Austin inventory has surged over the last 12 months, with active housing inventory increasing to 10,913, a 41% increase over 2019 levels. The All-Transactions House Price Index for the Austin-Round Rock-Georgetown MSA shows a 9% decline as of first quarter 2024 since peaking in the second quarter of 2022. However, the index remains up 57% over the last five years and 132% over the last 10 years.

LAND-SECURED DEALS DESERVE CONSIDERATION

Well structured, land-secured deals have the potential to provide strong collateral to investors and may merit investment consideration on a case-by-case basis.

The California “dirt bond” market seems to have a fair number of positives because of the solid security structure of popular Mello-Roos bonds. And, although repayment is always a concern, only 3% of the $10.7 billion in land-secured bonds outstanding are classified as distressed.

Colorado issuance climbed to a record high $2 billion in 2021 and $1.7 billion in 2022, but issuance declined to $558 million in 2023 and $314 million in 2024 year-to-date through June. Colorado’s land-secured credits have a similar risk profile to credits issued in Florida, with affordability remaining a concern. However, underlying fundamentals and favorable demographic trends should continue to support the market.

The Florida market retains an elevated risk profile relative to California. However, new issues over the past few years have generally been smaller in size, secured by a lower number of planned lots and generally less leveraged. These recent issues should fare better than those issued in the mid-2000s prior to the housing market collapse in the late 2000s.

Texas land-secured issuance slowed in 2022 and 2023 due to higher interest rates, and that trend has continued in 2024 with only $209 million in issuance to date. While Texas PID deals have an elevated risk profile relative to California, Nuveen views them as less risky than their counterparts in Colorado and Florida.

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Land-secured municipal bond analysis requires seasoned knowledge of individual credits and sound understanding of local markets. The three most important factors to consider when investing in this sector are location, strength of the development group and collateralization (i.e., the value of the land relative to land-secured debt issued).

Analysts must apply a disciplined approach in assessing the credit characteristics of each deal while maintaining a thorough understanding of the macroeconomic factors affecting the sector.

For more information, please visit nuveen.com.

Endnotes

Sources

New Construction Data and New Household Formation statistics: FRED; California: Bloomberg and California Association of Realtors; Florida: MBS Capital Markets attributed to the new issuance data within Florida; Colorado: S&P Case-Shiller for the home price appreciation, Bloomberg for the issuance data, and https://worldpopulationreview.com/states for the population data.

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