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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.

Pent-up housing demand. While new home construction activity has experienced strong growth in recent years, this growth has failed to keep pace with the rapid increase in new household formations. According to data collected by the U.S. Census Bureau, roughly 6.5 million new, single-family homes were constructed throughout the country from 2012 to 2020, falling well short of the 11.7 million in new household formations over the same period.

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 $12.9 billion in land-secured bonds outstanding, with only 1.8% 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 2020, land-secured municipal bond issuance in California was very strong, with aggregate issuance across the state of roughly $1.8 billion. This represents a drastic, 35% increase over 2019, and is just short of the record $1.9 billion in 2015.

Moving into 2021, California's housing market continues to be well-positioned to post another year of strong activity, as demand for single-family homes continues to accelerate faster than new homes are completed. In April, the median price for a single-family home in California exceeded $800,000 for the first time, representing a staggering 34% increase from just one year ago and a 50% increase over the past five years. Homebuilders are expected to continue to capitalize on these dynamics and work to narrow the gap between the ever-increasing demand for single-family homes and the supply of existing homes.

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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 increasingly working 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.

FLORIDA: PRIMED FOR CONTINUED GROWTH

Land-secured bonds in Florida are known as Community Development Districts (CDDs), which are secured by an annual assessment levy upon each planned lot/land parcel through maturity of the bonds. From 2016 to 2020, aggregate new money volume in Florida CDD bonds totaled more than $3.7 billion, while total volume (i.e., new money and refinancing) during 2020 exceeded $1 billion for a fifth 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 to better meet demand.

Over the longer term, the Florida CDD sector is primed for continued growth, with both population and household formations expected to increase at levels exceeded only by Texas through 2025. According to a report released last year by the Demographic Estimating Conference, Florida's population is forecasted to average more than 270,000 net new residents per year (743 per day) through 2025. This projected growth is equivalent to adding a city the size of Orlando every year.

At the outset of the COVID-19 pandemic, the impact on Florida's housing market was highly uncertain. Many land developers and homebuilders were judicious toward new housing starts and cautiously acquired new land through the second quarter of 2020. That trend proved to be short-lived, as the state's housing market has skyrocketed since then, driven by an extraordinary influx of new residents fueled largely by first-time buyers and retirees.

Many real estate experts predict that the Florida market for new homes will continue to escalate well into 2023, as the supply of single-family homes at affordable prices remains well below ongoing buyer demand driven primarily by the millennial demographic. This long runway for growth should continue to benefit the Florida CDD market as developers and builders remain thirsty for new land opportunities.

COLORADO: SPURRED BY POPULATION GROWTH

The vast majority of land-secured bonds in Colorado are issued through special taxing districts called Metropolitan Districts (MDs) and are generally 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 early development state districts – 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, remains strong. The S&P CoreLogic Case-Shiller CO-Denver Home Price Index has increased 44% over the five years from March 2016 to March 2021 and 13% from March 2020 to March 2021. The national index increased 38% and 13% over the same periods, respectively.

Land-secured issuance in the state has increased significantly over the past several years. Total new issue volume has grown from less than $100 million annually post the Great Recession to more than $1 billion in 2018 and a record high $1.7 billion in 2020.

Ongoing population growth, particularly along the Front Range, is the main driver of issuance. From 2010 to 2020, the state's population increased by 15% (1.5% annually), ranking Colorado as the sixth fastest growth rate and ninth in terms of population increase. The state is expected to follow similar growth trends over the foreseeable future.

Overall, favorable demographic trends support the Colorado housing market, the credit quality of Colorado land-secured credits, and the likelihood of continued robust municipal market issuance. The biggest concern surrounds affordability. Even with a moderate rise in interest rates, underlying fundamentals should continue to support the market.

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 $237 million in bonds across nine issues are currently classified as distressed.

The Florida land-secured bond 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 later 2000s.

The Colorado market has become increasingly active over the past few years with record issuance in 2020. Colorado's land-secured credits have a similar risk profile to credits issued in Florida, though fundamental factors currently support these credits.

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 prudent understanding of the macroeconomic factors affecting the sector.

For more information, please visit nuveen.com.

Endnotes

Sources

Bloomberg, L. P, U.S. Census Bureau

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