Commentary

LOOK OUT BELOW: INVESTORS ARE BUYING & FORECLOSING CFD INFRASTRUCTURE BONDS TO ACQUIRE NEW HOUSING SUBDIVISIONS

by Wald Realty Advisors

So I'm sitting at lunch with some of the other speakers at a recent commercial loan workout conference (I was speaking on the use of receivers to complete and sell new housing projects), and someone mentions that vulture investors are buying, and in some cases foreclosing on, CFD and Mello Roos bonds to acquire distressed tract housing developments.

He goes on to explain that the construction loans that finance new tract housing developments are frequently subordinated to the Community Facilities District (CFD) or Mello Roos bonds that are used by developers to finance the extensive and expensive infrastructure (streets, sidewalks, utilities, etc.) in a new housing subdivision. As a result, when no one is making the bond payments, since the developer is gone and there are no homeowners yet to make the bond payments, the bond holder can foreclose on the housing subdivision - wiping out the construction lender, and everyone else with lower priority liens.

That leaves the construction lender with three options: 1) Bring the CFD bonds current and keep them current (through the developer or a receiver, or after they've completed their foreclosure); 2) Try to buy the bonds outright; or, 3) Lose the housing subdivision (the collateral) to foreclosure by the bondholder.

As a result, vulture investors are starting to look for non-performing CFD bonds and buying them at steep discounts to their face value, with the expectation that they will receive a very high return if the bonds are brought current, or to acquire the underlying real estate at a deep discount and then resell it to another developer.

It's a pure financial play, so these vulture bond investors are particularly focused on housing subdivisions with completed entitlements and construction. If entitlements are not yet perfected, then they're forced to become developers themselves in order to preserve the public agency approvals. Incomplete construction makes for a fairly complex and lengthy due diligence effort to determine the additional cost to complete the subdivision infrastructure. Both represent challenges that most of these investors are not equipped to address.

So, if construction lenders don't have enough problems already, they need to be on the lookout for defaulted CFD and Mello Roos bonds on their non-performing housing subdivision construction loans. It's no longer enough to just focus on the non-performing developer and guarantor that sits above you in priority, you've got be looking out below.

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