Rural Real Estate Markets and Conservation Development In the Intermountain West: Perspectives, Challenges and Opportunities Emerging from the Great Recession

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Prepared for the Joint Venture of the Sonoran Institute and Lincoln Institute of Land Policy as part of its land-use planning and growth management research and policy analysis agenda focused on land conservation and improved urban form in the West.

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Abstract

Across the Intermountain West, the wide-ranging impacts of the feverish growth in both first and second home ownership, as well as the acquisition of rural properties as investments, are just beginning to be understood. It is evident, however, that the legacy of the past decade's "boom" and its collapse has left many local real estate markets, financial institutions, developers, development projects, and new property owners in distress. This distress can be witnessed in an extraordinary oversupply of vacant lots and built product, declining values, and a loss of product differentiation and pricing power in local markets.

This background report will explore potential opportunities for conservation development projects in the Intermountain West, particularly in meeting the types of real estate demand likely to emerge as the U.S. economy heals. The market's potential appetite for innovative subdivision approaches that incorporate homesite clustering along with significant open space set-asides for land conservation, viewshed protection, natural resource and wildlife habitat preservation, and sustainable agricultural production will be examined.

The report also will identify the probable factors driving these emerging appetites and the changing market in exurban land development. These factors include shifting consumer attitudes, impacts of the financial crisis on economic fundamentals such as demand and effective purchasing power, and demographic trends impacting future growth across the Intermountain West.

About the Authors

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Bruce also has broad experience in the application of GIS in evaluating land use alternatives within the master planning process. He has also worked extensively with landowners and their advisors in the planning and implementation of conservation easements to meet specific land preservation objectives.

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About Western Lands and Communities

Now in its seventh year, Western Lands and Communities is a partnership of the Lincoln Institute of Land Policy and Sonoran Institute focused on shaping growth, sustaining cities, protecting resources, and empowering communities in the Intermountain West. We address these challenges through research, tool development, demonstration projects, engaging policy makers, and education.

The joint venture currently emphasizes these major initiatives: state trust land management, smart growth tools, reshaping development patterns, western megaregions, climate change mitigation and adaptation, and Superstition Vistas – a sustainable development pilot project.

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Rural Real Estate Markets and Conservation Development In the Intermountain West: Perspectives, Challenges and Opportunities Emerging from the Great Recession

Introduction

As economists and historians continue to debate its causes, effects and ultimate duration, it is safe to say that the "Great Recession" that began in late 2007 has effectively ended one of the most dramatic real estate booms in this nation's history. If nothing else, the reset in property values experienced nationally across virtually every real estate market segment and its acknowledged connection with a near-collapse of the financial system worldwide has challenged the oft-held notion that the dynamics and determinants of real estate market behavior are purely local.

The severe economic contraction precipitated by the meltdown of financial markets in late 2008 and the resulting loss in household wealth, employment stability and access to credit has shifted consumer attitudes regarding real estate ownership, while significantly altering the fundamentals affecting supply and demand. The depth and duration of these changes are not yet fully known, and previous post-WWII recession-recovery models reflective of more conventional downturns may offer little guidance.

Prior to this collapse, rapidly escalating real estate values, significant population growth, and speculative subdivision activity in both primary and second home markets had noticeably impacted affordability, lifestyle, and resource sustainability across the Intermountain West. Concurrent with a growing recognition of these impacts by local governments and community residents, consumers absorbed a significant economic shock from the record gasoline prices of mid-2008. Public perception also began to acknowledge the prospect of global climate change and its potential physical and economic consequences.

These factors contributed substantially to tipping the U.S. consumer toward an active desire for products and services focused more on longer-term sustainability and "green" paradigms. Benefiting from this attitudinal shift, conservation development initiatives incorporating significant land set-asides for resource conservation and open space protection gained increasing appeal as an alternative to conventional exurban subdivision.

Conservation development approaches considered by this report will be particularly relevant to areas in the Northern Rockies high in wildlife and agricultural values and rich in scenic viewsheds and other natural amenities and features. As such, these approaches may apply at the developing edge of small cities and towns seeking to maintain their rural identity and heritage, as well as to other rural and agricultural areas.

Content of this report will inform participants in the "Reshaping Development Patterns" initiative of Western Lands and Communities, a joint venture of the Lincoln Institute of Land Policy and Sonoran Institute. This multi-year effort is being convened to develop best practices for reshaping unsustainable development and entitlement patterns in the

West. This background report is one of a series that cover relevant economic, legal, and land use perspectives.

Specific goals and objectives for this report include:

1. Briefly review significant rural real estate trends impacting the Northern Rockies and the Intermountain West over the past 25 years and how land development has evolved during these periods of market activity.

2. Identify paradigm shifts in consumer attitudes, behavior, and buyer expectations toward real estate investment and second home ownership, given the recent reset in the economic fundamentals previously underlying consumer demand.

3. Explore the potential impacts of the real estate market's collapse on rural land values and regional demand for first and second home development.

4. Define "Conservation Development" and what typically differentiates it as an alternative approach to conventional rural subdivision.

5. Identify the factors influencing both supply and demand for Conservation Development and evaluate its potential to satisfy market appetites in the future.

6. Consider Conservation Development's potential in addressing land use challenges left in the wake of the real estate market collapse, including whether this approach could provide economic benefits adequate to encourage reorganization of existing entitlements in areas now facing extreme oversupply of rural real estate inventory.

This report is not intended as a comprehensive review or a rigorous, quantitative research study. Rather, it is a primer and general overview of rural real estate markets and Conservation Development's potential application to a defined set of issues and concerns specific to the Northern Rockies and the greater Intermountain West in general.

Section I: Rural Real Estate Markets – Historical Perspective

The Intermountain West has been the nation's fastest growing region over the past 20 years.[1] This region extends from the eastern side of the Sierra Nevada and the Cascades in California and the Northwest, to the eastern margins of the Rocky Mountains in central Montana, Wyoming, Colorado, and southward through New Mexico. As a result, a range of sub-markets and micro trends now exist across the region. Markets of the Northern Rockies share many similarities, but also distinct differences from those defining the "megapolitan" areas of the Colorado Front Range, Arizona's Sun Corridor, Utah's Wasatch Front, Greater Las Vegas, and Northern New Mexico.

The 1980s to the Early 1990s: Recessions and Recoveries

This period was bracketed by national economic downturns at both ends. The severe recession of 1981-82 marked the second leg of a double-dip recession, the first half of which occurred during 1980. Rural land values in various markets of the Northern Rockies first began to decline in 1982, beginning a 10-year market cycle that ended with the recession of 1990-91.

Representative of markets in the region, Montana lost upwards of 60 percent of its value associated with rural lands during this period.[2] At that time, these markets were driven largely by agricultural and natural resource use and in-state buyers. This precipitous drop in value resulted from financial stress on highly leveraged agricultural properties impacted by steep declines in agricultural, energy, and other commodity prices.

Supply and demand were reflective of local area economies, as land use influences were dominated by agriculture and resource extraction industries. Typical subdivision associated with intermittent growth around the larger population centers was evident. Speculative rural subdivision was also triggered as some states, such as Montana, ended certain exemptions from county subdivision review, motivating landowners to subdivide before the exemptions were closed. Though platted, many of these lands were never developed. Some plats were later extinguished through conservation easements; others remain yet today in the form of "paper subdivisions" still accessed by unimproved roads or easements with little or no utility infrastructure in place.

During this period, a majority of states enacted enabling legislation for conservation easements. By the late 1980's, their use as a land preservation tool gained prominence in areas of the country seeing increased development pressure, though they were not yet prevalent in the Northern Rockies or the greater Intermountain West.

The Mid-1990s into the New Century: Dot-Com Wealth and "A River Runs Through It"

By 1990, areas including Montana saw their land values begin to recover due to an increased influence from out-of-state buyers purchasing larger properties.[3] Subsequent years marked what has been described as the re-discovery of the American West, as Internet technology and the digital revolution transformed business and the U.S. economy in ways not seen since the changes brought about by the automobile and the light bulb 100 years earlier.

As online technologies fundamentally changed the workplace, the Intermountain West's "clean slate" became irresistible to the baby boomer demographic and their children. Its open spaces, natural amenities, independent spirit, and recreational appeal attracted ever-increasing numbers of younger, outdoor-oriented professionals and entrepreneurial businesses no longer bound to established population centers.

While growth in the central and southern states of the Intermountain West was already well underway, the Northern Rockies began to experience an initial surge of in-migration during the early- and mid-1990s. The Flathead Lake region of northwestern Montana and the mountains and inland lakes of northern Idaho gained popularity as accumulated wealth from west coast states and other metropolitan areas bought into the area. In the Greater Yellowstone area, Jackson Hole, Wyoming became a premiere destination rivaling Colorado's ski resort areas. Exclusive upscale developments such as the Yellowstone Club, announced in 1999, ushered in an era of highly amenitized club concepts and private resort communities targeting out-of-state buyers with second home appetites and newly minted wealth from the technology boom.

While its mountain communities were the first to experience effects of the growth in second home and recreational real estate development, larger cities and towns located in the region's desirable river valleys also became favorites of this first wave of settlers to the New West. Established residents often referred to this as the "River Runs Through It" effect, as the acclaimed 1992 film's popularity drew worldwide attention to the region's natural beauty and lifestyle possibilities. Property values increased appreciably, and rooftops appeared on ranchlands and timbered hillsides previously thought of as too remote to ever see development.

The 1990s brought increased interest in land conservation. Between 1988 and 2003, the amount of acreage protected by conservation easements increased by over 1,600 percent nationwide. During this same period, the number of land trusts doubled to over 1,500 nationally,[4] while local, regional, and national land trusts operating in the West increased substantially. By 1999, surveys began to show larger and larger properties ranging from 10,000 to 200,000 acres or more in size were now being protected by conservation easements.[5]

The first significant Conservation Development projects in the region emerged during the latter stages of this period. Developers seeking product differentiation in resort markets and landowners sensing a market niche for “limited” development launched innovative projects with varying degrees of success. Potential tax benefits associated with donated conservation easements were often significant incentives in the structuring of these projects, often characterized by the market as “shared ranch concepts.” Early retail market acceptance was largely limited to projects offering a suite of upscale private amenities in resort markets where developable land near destination public amenities such as ski areas had become scarce. Other projects, attempted in more remote “second tier” locations, were not recognized by the market and did not achieve sufficient pre-sales volumes to move beyond their planning stages.

This period effectively concluded when the combined effects of the collapse of the dot-com bubble and the 9/11 attacks resulted in a mild contraction in the economy in 2001. While this recession was considered shallow by a number of metrics, the shock of 9/11 had a brief, but notably chilling impact on recreational real estate development in the Northern Rockies. Capital markets retrenched over the remainder of 2001 and 2002 to re-evaluate their exposure to projects in light of uncertain impacts to consumer mindsets.

The Mid-2000s: Post 9/11 and the New Land Rush

No longer confident in equity markets after the tech stock crash and a wave of corporate accounting scandals, investor culture collectively turned to what had traditionally been a secure long-term investment – real estate. Real estate was easy to understand in comparison to tech stocks, prices had never dropped on a national scale, and mortgage-backed securities had a long history with no record of default.

As Ralph Block, an independent advisor to real estate industry investors observed in 2005, "Many baby boomers appear to have decided that the stock market won’t provide them with sufficient assets with which to retire, and have taken advantage of “hot” real estate markets and low down payments to speculate in residential real estate.”[6]

Home ownership boomed nationwide, fueled by consistently low interest rates, lending practices energized by debt securitization, exotic home loan products, and relaxed underwriting standards enabling easier access to credit by marginally qualified borrowers. As soaring home prices drove up accumulated equity in primary residences, the financial trade press promoted ownership of second homes and rural property as an important component in diversified wealth building strategies for retirement. The ability to enjoy them as near-term vacation retreats created an added benefit. This fed the convergence of trends recognized by American Demographics’ founder Peter Francese in 2001 when he observed, “Over the next decade or two, owning a second home could become as prevalent as owning a third car.”[7]

With its established cities and towns already attracting a mobile baby boomer cohort and its destinations for outdoor recreation already well known, the Intermountain West was ripe for development in both primary and second home markets. Not surprisingly, it experienced a boom in both. In the Northern Rockies, vast pools of investor capital enabled through increasing leverage and the credit bubble led to a rapid proliferation of projects in mountain resort areas and in the region's river valleys and fly-fishing destinations. Those areas that had seen their first in-migration wave in the 1990s now experienced an even bigger second wave, with extraordinary increases in land values rippling further and further out into surrounding undeveloped agricultural areas.

At the same time, virtually all of the region's population centers saw an increase in real estate values as well. In larger cities such as Billings, Montana, confidence in a diversifying economy and easier access to credit allowed more and more renters to become homeowners, while many established homeowners "traded up," building larger homes in new subdivisions on the city's developing edge. Smaller cities such as Bozeman, Montana, rich in natural amenities, proximity to outdoor recreation, and college town culture were promoted in annual lists of "best places to live/retire," fueling unprecedented growth and stimulating speculative land development.

Late 2006 into Early 2008 – Hissing Sounds of a Deflating Bubble

Economists now believe that housing prices in the most overheated U.S. markets first began correcting in the spring of 2006. In August 2006, economist Nouriel Roubini warned that the United States was headed for a recession "much nastier, deeper and more protracted" than the 2001 recession."[8] He also noted, "This is the biggest housing slump in the last four or five decades," further commenting, "the impact of the bursting of the bubble will affect every household in America, not just the few people who owned significant shares in technology companies during the dot-com boom."[9] The sub-prime mortgage crisis would follow in 2007, developing into the broader credit crisis that continued on into 2008.

In the Northern Rockies, real estate markets remained brisk through 2006 and into 2007. In western Montana, sales volumes for larger ranches and rural parcels saw peaks in 2005 and 2006. Prices increased at rates of 10 to 30 percent annually as lands near desirable population centers rapidly moved from agricultural use to probable development use based on demand projections anticipating hundreds of lot sales per year in these areas.[10]

Prices reached a plateau in 2007, as sales volume dropped significantly that year. The market began to lose its appetite for acquisition of larger parcels for speculative development as the early stages of the credit crisis took hold while existing subdivision inventory continued to climb. Although numerous projects were still working their way through the entitlements pipeline, initial planning for new projects began to tail off as 2007 wore on into early 2008. In Billings, a market recognized as steadily appreciating but not overheated during the boom, 61 new subdivisions were platted between 2005 and 2008, containing 3,155 residential lots. By the end of 2008, less than one third of those lots had been built upon.[11]

By 2003-04, Conservation Development concepts had begun to attract more interest. Buyers of larger parcels for development looked for differentiation from the flood of conventional rural lot product coming to market. Established landowners looked to this innovative approach as a mechanism to extract the development value of their largest asset while preserving as much of the land's character as possible. At the same time, passage of the Pension Protection Act of 2006 enhanced tax incentives for charitable contributions from donated conservation easements, further arousing interest in strategies for integrating development with land conservation.

A number of new projects based around this approach were announced across the Northern Rockies region. Pioneering projects such as the Sand Creek Ranch Conservation Community near Buffalo, Wyoming, and Blackhawk on the River near McCall, Idaho were successfully launched and achieved genuine market acceptance. These projects realized some of the pent-up demand for conservation development products that had been building since the impact of 9/11 had chilled their progress several years earlier. At the same time, buyers seeking rural real estate as a longer-term investment quality asset began to grasp the value propositions associated with these development concepts.

Notably, these projects continued to show meaningful sales activity in their local markets even after sales of conventional subdivision product had noticeably tailed off from late 2007 into mid-2008. Sand Creek Ranch closed on the initial 16 percent of its inventory during this period. By the latter part of 2008 however, sales for these projects too had stalled, as markets across the board were stricken by the effects of the financial crisis and ensuing economic contraction on consumer confidence.

Late 2008 to Present – Meltdown, Nuclear Winter…and Green Shoots?

The deflating housing bubble and national slowdown further engulfed the Northern Rockies as 2008 wore on. Markets quieted further throughout the year. The collapse of Fannie Mae and Freddie Mac in mid-summer underscored the depth of the problems at hand. The Lehman Brothers bankruptcy filing on September 15, 2008 is often recalled by developers, industry consultants, and real estate professionals in the region as "the day the phones stopped ringing."

In western Montana markets considered indicative of the region, sales volumes with respect to properties greater than 1,000 acres in size had by the end of 2008 showed approximately 75-percent decline from their 2005 peak. Sales of subdivided lots near towns and population centers had experienced similar declines, coming to a virtual standstill in many markets. Notably, there did appear to be some continued life in the market for larger ranch properties with world-class natural amenities along river corridors in demand locations, with prices for these properties generally holding at levels consistent with the previous 12 to 24 months.[12]

Data for 2009 is still being analyzed for many areas. Due to dramatic declines in sales volumes these data are limited, and depth and specificity of trends is, as yet, hard to identify. Anecdotal evidence suggests further declines in the market. In August 2009, Billings-based ranch brokerage Hall & Hall noted that since the fall of 2008, $160 million worth of the firm's contracts had fallen through. Prices of the few ranches still selling were down 20 percent over the previous six months, and the firm's total ranch sales in the Jackson Hole area had shrunk from $1.2 billion in 2007 to only $50 million for the first half of this year.[13]

Similarly, the United States Department of Agriculture reported in its 2009 summary of land values that farm real estate values experienced a rare drop nationally from 2008 levels. This included an average decline of 11 percent in the mountain states, which includes the Intermountain West.[14] In the Northern Rockies, Idaho, Montana, and Wyoming each experienced declines across all land types as summarized in the table below.

	Idaho	Montana	Wyoming
Aggregate Farmland Values	-12.0 percent	-22.2 percent	-7.1 percent
Pasture Land Values	-20.5 percent	-30.3 percent	-14.6 percent
Cropland Values	-6.8 percent	-3.0 percent	NC

Some national analysts have pointed to drops in livestock commodity prices as the factor driving these declines. However, conversations with local appraisers and other real estate professionals suggest they are more indicative of a significant correction in the values associated with speculative development of transitioning rural agricultural lands in these states, following dramatic drops in demand for second homes and recreational real estate.

<u>Recession vs. Reset:</u> The severe economic contraction of Q4 2008 and Q1 2009 began to moderate in the second quarter of 2009. Economists seem to agree that the world financial system most likely avoided a full-scale collapse, and world economies have stepped back from the abyss. Propped up by the largest fiscal stimulus in history and the Federal Reserve's aggressive attempts to increase liquidity in response to the financial crisis, the U.S. economy managed a positive GDP reading in Q3 2009. Many economists believe the recession may have technically ended sometime during the summer months.

However, while economic free fall has apparently been arrested, opinions diverge as to the shape and trajectory of the anticipated recovery. It is generally agreed that significant damage has been done to the U.S. banking system; reform will be slow and many of the misaligned incentives that led to the near total collapse of many financial institutions still remain. Lending activity remains constrained as these institutions repair their balance sheets. At the same time, consumer balance sheets have also been decimated and will take time to repair as well, while unemployment rates remain stubbornly high. Impacts of structural deficits and unprecedented actions by central banks to boost liquidity are still playing out, and the economy remains vulnerable to external shocks.

Despite early hopes for a strong rebound, consensus is building that the recovery is likely to remain tepid, uneven, and fragile for some period of time. Perhaps Microsoft CEO Steve Ballmer characterized it best in early 2009 when he described the Great Recession as "a fundamental economic reset" for an economy that has grown largely through its reliance on unrealistically cheap debt over the last 25 years.[15]

Impacts to Communities of the Northern Rockies – Teton County, Idaho: In real estate markets of the Northern Rockies, this reset has left a vast supply of current and prospective inventory in areas that grew fastest during the boom. The Teton Valley market in Teton County, Idaho, adjacent to Jackson, Wyoming presents an example.

Conversations with local real estate professionals indicate that in this market, residential home sales volumes increased at rates approximating 25 to 35 percent year over year during the peak period of the boom. These volumes have fallen sharply since, at annual rates of decline approaching 30 to 40 percent or more during 2007-08, with little 2009 sales activity.

Over the same period, residential lot sales volume grew at reported annual rates approximating 35 to 55 percent, peaking as high as 145 percent in 2006 (also reflecting the expiration of a 2005 subdivision moratorium), before declining nearly 10 percent in 2007 and then by as much as 85 percent in 2008, with little sales activity evident in 2009.

MLS statistics as of early March 2009 showed 914 active residential lot listings.[16] Sales volumes returning at levels similar to those reported for 2002-03 (averaging around 150 unit sales per year) would absorb this listed lot inventory in six years. However, the county also has experienced over $156,000,000 in foreclosures in 2009,[17] creating a prospective shadow inventory that could multiply this theoretical absorption period for actively listed inventory.

A brief review of total rural subdivision lot inventory in the county underscores the impact of the boom and its collapse on Teton County. In the unincorporated areas of the county (areas outside of town limits), approximately 9,200 lots have been recorded in total, nearly all of which have been platted since 1970. The 15 years from 1995 thru 2009 saw roughly 70 percent of these lots recorded – with over 55 percent, or more than 5,000 lots, recorded during the latter half of the period from 2002 to 2009.[18]

Countywide inventory statistics[19] available as of September 2009 include:

- A total of 9,194 recorded lots exist in the unincorporated county, 6,946 of which are vacant.
- A total of 307 building permits were issued in the county in 2007, with 148 issued in 2008. More recent activity has receded dramatically from these levels. Since January 2009, there has been one new construction building permit issued in the town of Driggs, none in the town of Victor, and 23 in the unincorporated county.
- Assuming building permits were to rebound to an assumed average of 100 new permits per year in the unincorporated county, it would take nearly 70 years to absorb the current vacant lot inventory.

Because Teton County regulations allow for lots to be sold immediately upon final plat recording, consideration of potential new inventory at various stages of the entitlement process is also relevant in evaluating supply and demand dynamics going forward.

As of September 2009, there were 39 pending subdivisions with a total of an additional 3,583 lots reported to be in the entitlements pipeline.[20] These pending subdivisions reflect project types ranging from straightforward rural subdivisions of a dozen or so large lots to highly-amenitized, multi-phased master planned resort communities with hundreds of lots of various sizes. Their timelines and current status for final approval and release to the market are not certain. Given the financing constraints and flat demand currently in evidence, it is reasonable to assume that not all of them will advance to final recording.

However, the potential impact of this additional supply, in addition to vast oversupply already existing in the county, could have important implications for buyers, sellers, and developers in this market. Adding 3,583 more lots to the county's existing 6,946 vacant platted lots would create a vastly disproportionate 10,529-lot inventory in a county with estimated population of 8,833 people.[21] Even at the extraordinary level of 307 annual building permits experienced during peak years of the boom's real estate and credit bubbles – conditions unlikely to be repeated soon – it would take nearly 35 years to absorb this inventory.

Section II: The Road Ahead – The Market's Return Post-Collapse

Consistent with national markets, sales activity in both primary- and second-home markets of the Northern Rockies came to a virtual standstill in Q4 2008 and Q1 2009. Buyers adopted a bunker mentality as they absorbed the financial crisis unfolding worldwide, severe contraction in virtually every sector of the U.S. economy, and the unprecedented government intervention that followed.

In the months since, primary residence buyers have begun to return to the market in many hard-hit regions of the country, including megapolitan areas of the Intermountain West. Initially, half or more of sales transactions were driven by speculative buying to acquire distressed property inventory.[22] However, many markets are now seeing more sustained activity from homebuyers capitalizing on temporary federal tax credit incentives as the bubble's collapse has driven prices down and affordability to all-time highs. While early signs of stabilization in the hardest hit markets have fueled optimism for a housing recovery, activity remains concentrated at the lower end of the markets where stimulus efforts are having the greatest impact. Higher end real estate has generally not yet experienced a similar rebound.[23]

Sales volumes in the Northern Rockies real estate market declined region-wide in 2008, a trend that has continued to date. Downward price pressure is evident in most locations, with the fastest-growing markets over the recent five- or six-year period experiencing the biggest declines. Some markets have collapsed, while others are better described as "substantially correcting." The timing, extent, and shape of recovery are likely to be uneven across the region.

Fundamentals Impacting the Markets Going Forward

The "new normal" for the U.S. economy is now being defined.[24] As cautious optimism returns, real estate markets will digest the effects of fundamental changes to the environments underpinning consumer demand and buyer behavior during the past several years. These include the following:

1. Destruction of Household Wealth
2. De-Leveraging of Household Balance Sheets
3. Credit Contraction and a Diminished Velocity of Money
4. Long-Term Employment Instability
5. Reduction in Discretionary Purchases

The extent of these impacts on the individual markets of the Northern Rockies and the greater Intermountain West will be largely influenced by the type of buyers that have driven their sales activity in recent years. These include primary residence buyers, second home buyers, retirement and recreational real estate investors, and speculators.

<u>1. Destruction of Household Wealth:</u> The interconnected collapse of housing prices and the equities markets has inflicted severe damage to net worth for a wide swath of U.S.

households. The Federal Reserve reported in March 2009 that households had lost over $5 trillion, or 9 percent, of household wealth in Q4 2008 alone and over $11 trillion, or 18 percent, over the course of 2008. By comparison, household net worth declined at a 3- percent annual rate in 2002 after the collapse of the tech stock bubble.

In previous post-WWII recessions, declines in wealth have primarily been associated with stock market losses, while aggregate real estate wealth has held, declined slightly, or continued to rise. The concurrent loss of equity in primary and second homes makes this recession unique.[25] This double-barreled diminution of wealth most affects many of those segments of the population with the greatest purchasing power. Middle income families, whose increased spending has been enabled by rising home equity and cash-out refinancing, have also been significantly impacted.

Although equities markets have rallied to recoup a significant portion of the past year's losses, U.S. net worth at the end of Q3 2009 is still slightly more than 18 percent below its 2007 peak.[26] For an economy that relies on consumer spending for 70 to 80 percent of domestic output, this damaging loss of wealth across the consumer spectrum suggests a drag on spending-fueled growth that is likely to be evident for an extended period of time. A re-direction of the current intergenerational wealth transfer, away from large discretionary purchases back toward retirement assets, also appears likely.

<u>2. De-Leveraging of Household Balance Sheets:</u> Prior to a rise beginning in Q4 2008, U.S. household savings rates had steadily declined since the 1980s. This decline reached its nadir in 2005-06, as savings rates actually turned negative. In 2007, U.S. households were borrowing at an all time high of 133 percent of personal disposable income.[27] Although households felt wealthy, they were not saving, as values associated with rising stock portfolios and appreciating retirement assets and real estate holdings continued to climb. The ability to borrow more and continually finance and re-finance increasing levels of debt at consistently low interest rates further fueled spending, feeding an illusion of wealth created through leverage and unrealized asset appreciation.

Experts have noted the economy's inability to sustain this level of household debt. As suggested by the Federal Reserve Bank of San Francisco in its Economic Letter of May 15, 2009, "…households may need to undergo a prolonged period of de-leveraging, whereby debt is reduced and saving is increased."[28] How long this period of de-leveraging lasts will depend largely on the shape and trajectory of economic recovery.

While recognizing its notable differences, the Japanese economy's experience in recovering from a simultaneous collapse of equities and real estate bubbles in 1989 and 1991 provides a relevant parallel. Nearly 20 years later, Japan's real estate prices remain 70 percent below their peak, with residential land prices still 40 percent below their peak. Japan's de-leveraging episode reduced debt ratios from 125 percent to 95 percent over 10 years. If U.S. households were to undertake a similar de-leveraging, debt ratios would drop to about 100 percent by the end of 2018, equivalent to levels last seen in 2002.[29]

The San Francisco Fed's newsletter concluded that, "Going forward, it seems probable that many U.S. households will reduce their debt." This could occur through increased saving and a corresponding decrease in spending, or through foreclosures and default on existing debt, which would have deeper ramifications for both households and the banking system. Barring dramatic increases to household net incomes, either of these outcomes would imply a fundamental change in both spending and borrowing patterns for a sustained period.

3. Credit Contraction and a Diminished Velocity of Money: Another influence on the shape of the economic recovery is the worldwide de-leveraging of financial systems now underway, and its impacts on future credit availability to U.S. consumers and businesses, including real estate buyers and developers.

The role of debt securitization as the "ungoverned engine" that enabled, inflated, and sustained the credit and housing bubbles has been well-chronicled. Regulatory reform to address the lack of transparency and misaligned incentives in the markets for financial derivatives is evolving slowly. In the meantime, debt securitization markets are barely functioning. These markets have supported virtually every facet of business, real estate, and consumer lending as a "shadow banking system" which had grown to provide up to 50 percent or more of the net new credit circulating throughout the U.S. in recent years.[30]

Until these markets fully stabilize and clear, access to both equity capital and debt financing will be substantially constrained in comparison to recent years. And yet while the financial systems that have defined it are recovering, the shadow banking system is not expected to return to its previous form and extent.[31] This suggests that the velocity of money moving through the economy which supported the explosive rates of growth and market activity experienced during the boom may not be seen again in the future.

4. Long-Term Employment Instability: The future of the job market has been perhaps the most vexing factor in predicting the timing, shape, and virility of economic recovery. Unemployment rates in the U.S. economy are currently at 35-year highs of 10 percent or more. Measures of "underemployment" currently track at more than 17 percent, affecting one out of every five to six workers, cutting across virtually every industry. Moreover, the speed and severity of job cuts across wide swaths of highly educated, high wage-earning sectors have unnerved the consumer and the U.S. workforce.

Not surprisingly, job anxiety has increased sharply, according to recent opinion surveys. An August 2009 Gallup poll found that 31 percent of workers worried about being laid off, and nearly a third thought their wages might be cut. Both of these numbers were up 50 percent from a year earlier. Economic forecaster IHS Global Insight currently believes the U.S. unemployment rate will still average 7.6 percent into 2014.[32]

The imprint of this decimation of the U.S job market on consumer psyche and buyer behavior going forward cannot be underestimated. Experts warn that persistently high unemployment rates are likely to reduce overall consumption in the economy, as even those who are working become more cautious.

5. Reduction in Discretionary Purchases: As the effects of lost wealth and the deepest economic contraction since the 1930s have taken hold, discretionary spending on big ticket items has plunged. Markets for expensive non-essential luxuries ranging from private aircraft and fine art to thoroughbred race horses have experienced steep declines.

Even at the height of the boom, many second homeowners indicated that they viewed their real ability to afford a second home as somewhat marginal; however, the notion that it was an "investment" that would only increase in value over time became the deciding factor in its purchase.

As its ability to generate highly profitable returns as an appreciating asset is now in question, spending on real estate other than for the essential need of shelter has become more discretionary. Second home purchases, in particular, have flat-lined even in premiere destination markets. As reported locally, sales of lakefront properties on Flathead Lake in Montana ceased during the first half of 2009, the first time in 26 years that no sales were reported during an entire six-month period.[33]

While spending on discretionary air travel and luxury hotel stays are down, visitation to national parks is up as families look for less expensive vacation options. Trends such as "glamping," a luxury form of camping that first appeared during the excesses of the boom, bear watching. Although "luxury" per se may be out of fashion, an adaptation of this trend could attract a significant segment of the second home buyer cohort for whom the financial viability of ownership is now questionable.

Where Real Estate Market Appetites May Be Headed

The factors outlined above suggest healing of the markets may be slow across various areas of the Intermountain West. De-leveraging, reduced net worth, eroded confidence, and a reduction in the velocity of money flowing throughout the financial system all imply that for most, spending will be driven more by income than debt, and wealth will now be accumulated through savings rather than bets on near-term asset appreciation.

So who are the real estate buyers of the future in the region and where will their preferences lie? There is no one answer. The question should be looked at from the perspective of real estate ownership objectives (primary residence versus second/vacation home) and location (resort areas versus population centers and the rural areas connected to them). Within a broad range of appeal, each geographic market in the region attracts a specific demographic and psychographic combination that defines its real estate demand.

Real Estate Industry Research Data: An industry survey completed during Spring 2009 offers an insightful look into trends emerging from the economic crisis with regard to real estate. "*Resort Real Estate Survey – Industry Perspective on Consumer Trends Emerging from Economic Crisis,"* published by Christopher Kelsey and David Norden on April 21, 2009, polled nearly 400 resort real estate and development industry professionals across the country, of whom 36 percent practice in the Mountain West.[34] Respondents included developers with direct equity interest in projects, those working on behalf of equity investors, as well as sales and marketing, design, financial, legal, and operational professionals and advisors. Over 75 percent of the survey's respondents indicated 10 or more years experience in the industry.

The survey sought to target opinions in regard to three primary questions: 1) how will the industry need to adapt as a result of the crisis? 2) will changes in consumer behavior be long lasting, or will short memories return spending patterns to those pre-recession? and 3) how will attitudes and appetites for second home ownership have changed when prospective customers return to the market? Notable findings from this survey[35] include:

a) The magnitude and long-term effects of the crisis are uncertain; a number of respondents expressed fears that a "second wave" of bad news may yet lie ahead.

b) Respondents pointed to vast amounts of patient capital parked on the sidelines in comparison to past recessions, the potential for a flight to hard assets including real estate should inflationary forces take hold, and psychographic trends reinforced by the crisis that should continue to support second home ownership, albeit at a different level and form, all as reasons for optimism.

c) Almost two-thirds, or 64 percent of respondents expected enduring changes to consumer behavior, defining a "new normal," though there will likely be some return to old attitudes and behaviors as the crisis fades into memory.

d) Changes in product offerings, such as smaller homes and more casual, less conspicuously consumptive amenities are expected to be in greater demand.

e) Respondents suggested a genuine trend toward economic responsibility, resulting in heightened cost consciousness of user fees and HOA dues. The trend will be toward "smarter" purchases combining a "value buy" with a sustainable ongoing cost of ownership.

f) "Responsible consumption" will become a new paradigm, as the crisis has reinforced the trend for environmental responsibility and stewardship. Demands are likely to go beyond basic conservation, to include sustainable food and alternative energy. This "new pragmatism" will be reinforced by GenX and GenY consumers into the future, well beyond the Baby Boomers.

Additional findings from the survey[36] specific to product types included:

g) Buyers have lost faith in the industry, and will significantly increase their due diligence; they will seek to reduce unknowns, looking first toward options in historically strong locales from developers with established track records.

h) Developers should expect reduced interest in vacant lots and pre-sale properties as buyers become more wary of the risks and extended timelines associated with construction.

i) Highly amenitized development concepts will need to deliver more of their vertical infrastructure and promised amenities in advance.

j) Preference for smaller homes and a back-to-basics ethic will be evident; golf and private membership clubs will be less in favor. Buyers will shy away from lavish amenity packages and complex ownership structures that suggest a high carrying cost of ownership or potential resale limitations.

k) Buyers returning to the market will expect a significant discount from pre-crisis price levels (at least 20 to 30 percent). Sales velocities experienced in 2004-06 are unlikely to return for at least five years or more.

l) Despite changed mindsets, respondents did not believe future buyers would be willing to completely forego the services and amenities that have become common at successful properties; rather, they will seek them in a more modest, reasonable and sustainable package.

Kelsey-Norden's initial survey represents one of the earliest and most comprehensive attempts to gauge impacts to both demand and supply-side psyche resulting from the economic crisis. While this survey sought to target attitudes associated with resort real estate and second home ownership, many of its findings may also be considered relevant to primary residence purchases in demand areas of the Northern Rockies and Intermountain West that experienced exceedingly high growth rates driven by speculative real estate activity.

Consumer Research Data: As suggested by the authors, at the time of the survey it was premature to query actual buyers for reliable trend information. However, attitudinal surveys of the wealthier cohort traditionally defining a primary segment of the recreational and second home buyer markets are ongoing.

The American Affluence Research Center (AARC) conducts semi-annual surveys of this group to assess their level of confidence in the economy and to preview how spending, saving, and investment patterns may evolve in the coming months. These surveys track 17 product and service categories, including real estate. A snapshot of summarized findings from AARC's Spring 2009 survey[37] includes:

a) The current business conditions index was at an historic low going back to 2001, as were the indexes for future household income and savings. All demographic groups expected that business conditions would be about the same in 12 months. There was also an expectation that personal income will be lower in 12 months.

b) These indexes suggest there is no expectation of a real economic recovery over the next 12 months, a notably gloomy outlook among these respondents who are often a leading indicator of economic conditions.

c) Preservation of capital is now the primary investment objective of the majority of respondents. This is a major reversal from previous surveys, where capital appreciation and growth was the dominant objective of most respondents.

d) More than two-thirds of the respondents indicated no plans to make major expenditures in the next 12 months. Acquisition plans for all eight of the major purchase item categories are equal to, or at, historic lows.

e) Over 80 percent said they had reduced or deferred expenditures in the past 12 months and would make a conscious effort to do so in the next 12 months. Uncertainty surrounding the economic recovery and a decline in the value of investments and savings were the most frequently mentioned reasons for reducing expenditures.

f) A total of 87 percent of the respondents reported a decline in the value of their primary residence; value of primary residences was estimated to have decreased by an average of 14 percent.

g) Over 90 percent of respondents reported declines averaging 33 percent in the value of their investable assets and savings.

h) Over 28 percent of the sample reported full ownership of a second home. An additional 15 percent reported partial access to a vacation home through a timeshare or via private residence or destination clubs.

i) Ownership of wholly-owned second homes was most prevalent among the $6 million-plus net worth group (64 percent yes) and the $1.5 to $6 million group (34 percent yes); the second home, at an average of $781,000, is typically valued at about two-thirds of their primary residence (approximately $1.2 million).

j) Only 4.1 percent of the respondents indicated serious consideration for acquisition of a wholly-owned second home, versus 9.8 percent in 2007.

These survey results clearly suggest a shift in attitudes driving consumption, as well as specific real estate buyer behavior. However, the depth and longevity of these trends is uncertain. Both surveys were repeated during fall 2009. Not surprisingly, after six months of substantial gains in the financial markets, AARC's fall survey showed improved sentiment, with all 17 category spending indexes higher than those recorded six months earlier. However, none are in positive territory, continuing a trend that first appeared in the spring survey.

Similarly, acquisition plans for all of the eight major item purchase categories, with the notable exception of building a primary home or vacation home, rose slightly from the spring survey. Plans for a major home remodeling showed the most substantial increase.

Perhaps most noteworthy, 20 percent of respondents reported that they have not changed their spending habits since the recession began. Of the 80 percent who have, roughly a quarter does not plan to return to their pre-recession spending levels. This equals roughly 20 percent of the wealthiest 10 percent of U.S. households.[38]

Resort Real Estate Survey #2 was published by Kelsey-Norden on November 1, 2009, with nearly 90 percent of their first survey's respondents again reporting. Notable findings of this update to their spring survey[39] included:

a) Nearly 40 percent of respondents based in the Rocky Mountain region expected their markets to show the first signs of recovery in late 2010, with 25 percent estimating 2011.

b) Nearly 85 percent of Rocky Mountain respondents continued to believe that property values in their markets had declined 20 to 40 percent, with 37 percent estimating a 30-percent decline.

c) Over 80 percent believed their markets were at least somewhat impacted by foreclosures, with nearly 25 percent believing the impact is significant. Over 75 percent estimated the current wave of foreclosures would last another one to two years.

d) Over 50 percent projected prices to remain at current levels until existing inventories are absorbed; 17 percent of respondents based in the Rocky Mountain states expected further price declines, while 33 percent based in the Southwest expected further declines; over 70 percent believed the shadow inventory in their markets (owners desiring to sell but waiting for market conditions to improve) would take a minimum of two to four years to absorb.

e) Roughly one-third of all respondents believed that 25 percent of the prospective buyers for vacation homes existing before the recession are gone forever; another 15 percent or so believed 50 percent of the market would never return.

f) Nearly half of all respondents believed that 100 percent of those considering second home purchases will need to be convinced that the purchase is a good value; roughly the same number believed that 75 percent of future buyers will want their second home to be part of increasing their health and wellness and connect them to a socially vibrant community.

The trends noted in these two surveys bear watching as shock from the financial crisis continues to fade, the shape and trajectory of the economic recovery becomes more apparent, and conditions in the equity and housing markets ebb and flow in the wake of the collapse of their respective bubbles.

The Real Estate Valuation Reset – "What's the Property Worth Now?"

The Intermountain West includes many real estate markets, from rural to megapolitan, and from primary residence to resort/recreational/second home. Estimates of property values now and in the future will, to varying degrees, be influenced by national trends.

Housing market analysts have recently suggested that home prices are stabilizing nationally, albeit unevenly from market to market. This has been due at least in part to the favorable timing of foreclosure moratoriums, temporary first-time homebuyer tax credits, and Federal Reserve intervention to ensure low interest rates, all coincident with the 2009 spring/summer home buying season. Such government intervention may have been helpful in slowing further price declines. However, many analysts wonder whether government efforts have merely created a pause in the housing market downturn. There are real questions as to how sustainable the benefits from this government intervention may be.[40]

Despite the recent modest uptick in home prices, one prominent asset management firm has forecast a range of scenarios projecting additional drops of anywhere from 8 percent to 19 percent in home prices from May 2009 levels.[41] Similarly, a senior Deutsche Bank research director estimated in August that U.S. home prices may fall another 14 percent before finally bottoming, leaving up to 48 percent of mortgage owners "underwater" (i.e. owing more than their home is worth) by 2011.[42] Though signs of stabilization have appeared in some housing markets as the U.S. economy has trended up in the second half of 2009, the sustainability of these market trends has been questioned by leading economists.[43]

How has the reset affected rural property values in the Intermountain West? Beyond the information presented earlier in this report, real estate professionals suggest a substantial market correction continues across the Northern Rockies. As of mid-summer 2009, sales volumes are reported to have declined as much as 80 to 90 percent from one year earlier. Given such a low volume of sales data, specific price analysis is difficult. Anecdotally, brokers in some areas report that offers may start as low as 50 percent of asking price for ranches and rural properties still priced at 2006-07 levels, and listing prices on others have been reduced up to 30 percent.

Conversations with appraisers and other valuation professionals suggest downward valuation shifts in the market of up to 20 to 40 percent or more. Kelsey-Norden's fall 2009 survey respondents collectively pointed to a similar decline, reflecting an industry-wide reset now underway for resort residential projects as many undergo re-capitalization, a change of ownership, or both. This reset in developer costs will facilitate an eventual reset in retail pricing of product to meet future market demand.

These trends, although recent, still evolving, and subject to deeper analysis and further confirmation by the markets, strongly suggest that the long period of appreciating land values in the Northern Rockies that began in the early 1990s has, for now, come to an end. This has ramifications both for future development patterns as well as absorption of existing inventory in many markets.

Previously, as escalating land values rippled out from resort areas and other desirable amenity centers, larger rural parcels farther from these destination centers were increasingly acquired for speculative development. Values for these lands now appear to be receding – in many areas returning to levels closer to agricultural use values – leaving only those areas nearer to destination centers with realizable development value in the near term. Prospective buyers and land investors returning to the market will most probably initially focus in these proven destination areas in, as some have phrased it, a "flight to quality." Longer term value investors will consider "value buys" in the more far-flung areas as those prices recede toward agricultural values.

At the retail level, market appetite will probably also retreat from recently developed product located furthest out from the most desirable destinations, town centers and signature recreational areas back toward established projects near these amenity cores, as reduced or distressed prices for these premium products will offer "value buys." This may reduce development pressure on transitional lands in second- and third-tier locations for an extended period of time.

The changes in the underlying fundamentals of consumer demand and buyer behavior described at the beginning of this section imply substantial constraints on appetites for discretionary second home real estate, as well as a loss in effective purchasing power for primary residences. Second home markets will also be impacted by the aging of the baby boomer cohort that is now nearly 10 years into the 20-year period of trend convergence cited by Francese in 2001.[44] A large contingent of the boomer cohort will need to focus on rebuilding lost wealth, leaving large discretionary purchases behind and passing on the dream of a vacation home to move straight toward retirement home acquisition.

As indicated by Kelsey-Norden's research, basic desires to own a second home will probably continue. However, some significant portion of the market is not just sitting idle, but more likely has actually vanished. These direct quotations from survey respondents[45] may reflect some of what lies ahead for markets previously impacted by a high volume of discretionary real estate purchases:

> *"The most significant driver in the price erosion for future sales efforts will be the existing inventory levels of all second home communities, which have ballooned. Those sales…will dilute value comps for years…" – Mountain W/NW Real Estate Developer*
>
> *"Consumer preferences won't change. Motivations and abilities will. Staggering inventory in existing locations will increase exponentially due to lack of financing, foreclosures and inherited / unwanted property." – Mountain W/NW Real Estate Developer*
>
> *"…The recovery will be marked by innovators. Those who try to go back to the old model will fail." – Mountain W/NW Real Estate Marketing Professional*
>
> *"Values will remain at current and reduced levels until inventory is absorbed after which prices will rise minimally, but prices will not (at least for 10 years or longer) recover anywhere near peak values." – Rocky Mountain U.S. Developer*

With the evaporation of people's net worth, a much more disciplined lending environment and what will likely be prolonged risk aversion going forward, resort real estate purchasers will be limited to those who can afford it, and only where they see established value and safety.   In other words, the places that did well before the building boom will recover gradually; most other developments will probably languish." – California Real Estate Marketing Manager

"The biggest challenge facing the second home industry is the extraordinary supply of unsold inventory. By the time that this gets absorbed, much of the demand that was driven by the Baby Boomers and the wealth effect of the late 90's and early 2000's will no longer be in place. As a result, while there will be a recovery, the biggest question will be whether the recovery will produce a market environment that will be self-sustaining. For all of these reasons, it will be a long time before meaningful new development occurs." – Real Estate Developer-All U.S.

Section III: Conservation Development – Meeting Markets of the Future

Since reaching an apparent bottom during the summer of 2009, world economies appear to have stepped back from the brink. Anxiety has ebbed, financial markets have rebounded, and cautious optimism surrounding a nascent recovery has replaced the fear and panic of one year ago. Despite this feeling of firmer footing, many economists, business leaders, government officials, policy makers, and consumers remain wary of prospective headwinds and the economic challenges lying ahead.

While financial markets have substantially recovered their losses of the past 12 months, broader conditions enabling growth at levels necessary for a sustained recovery are not yet present. Many forecast a scenario whereby the economy stabilizes at anemic levels of growth well below that of past recoveries, after a short-term bounce driven by government stimulus, rebuilding of inventories, and pent-up demand in certain sectors.[46]

However the recovery and overall health of the economy unfold, conversations with real estate professionals in the Northern Rockies imply a future very different from the steadily appreciating markets of the past two decades. Most foresee a smaller market with fewer active developers, less speculation, and a longer-term view, closer in character and velocity to what had been experienced in decades preceding the boom. With abundant inventory in most markets and some experiencing significant oversupply, along with concerns regarding a "shadow inventory" of distressed and unreleased product that may yet hit the market, downward price pressure may be felt for some period of time.

These market conditions, combined with changed fundamentals impacting the consumer suggest that future demand will be driven by an overall lower cost of ownership. For second home real estate as well as mid- and upper-tier primary residences in planned communities, the "value buy" – coupling acquisition at a discount with a more sustainable total ongoing cost of ownership associated with taxes, maintenance, and owners association fees – is likely to define demand into the future.

"Conservation Development" Defined

Conservation Development is an approach that seeks to lessen the impact of development on the land and to protect valuable attributes such as wildlife habitat, natural resources, and agricultural productivity. The terms "limited development" and "clustered development" have also been used to describe this approach.

Conversely, conventional subdivision strategies typically focus primarily on lot yield in defining the development outcome for a site. This strategy often significantly alters or eliminates natural features, habitat, and historic land uses to accommodate geometric lot layouts, street grids, and infrastructure designs that maximize lot yield.

Conservation Development looks beyond lot yield to focus on protection of a property's intrinsic character, use, and resource values. It is sometimes called "limited development" because it limits the area of land disturbed within the total project area; it does not, however, necessarily imply that the number of homes in the project is reduced. Rather, the homes are clustered in areas with the least significant conservation value, and the remaining land is preserved as open space. Conservation Development in this regard is similar to golf course development in that it concentrates homes around an area that provides amenities, recreational opportunities, and an open feel to its residents. In the case of Conservation Development, the amenity is not a developed golf course but instead consists of open space that preserves a traditional land use such as agriculture and/or natural features such as woodlands, wetlands, and scenic views.

As an example, a conventional rural subdivision of 300 acres might be developed with 100 lots of approximately three acres each, with little or no common open space available to all residents. In a Conservation Development approach to the same parcel, 200 acres of the property with the most significant conservation value might be set aside as managed, permanently protected open space owned by all residents, with the remaining 100 acres configured for individual home site development on smaller lots that are easier and less expensive to maintain.

This approach relies on a thorough inventory and up-front analysis of the natural amenities, resources, and physical attributes of the land parcel involved to identify the opportunities and constraints offered by the site's topography, vegetation, soils, water resources, and other natural features. This resource-based planning approach enables successful integration of homesites and the built environment within a significant land preservation strategy.

Conservation Development projects seek to meet a market niche that desires a meaningful open space component integrated into the development concept that preserves the inherent character and attributes of the land. This open space is often commonly owned, and is protected by community governance, deed restrictions, conservation easements, or all three. Financial engineering for these projects can also be quite innovative, structuring equity to realize tax advantages associated with land preservation.

A growing body of research has categorized Conservation Development in different ways, including by absolute or relative development density, volume or percentage of open space acres protected, conservation values, ecological impacts, and/or economic models, as well as through other criteria. Each of these studies has value in gaining a better understanding of this approach as it moves beyond its early adoption phase and into the mainstream.

In addition, there is a significant body of literature that explores the financial calculus involved in subdivision projects that reduce the number of home sites and increase undeveloped open space. This research indicates that, while limiting the number of lots naturally results in fewer units sold, it can increase the value of each inventory unit. The value to the homebuyer of the open space amenity in a limited development project, coupled with an increase in the scarcity of home sites available within the subdivision, often exceeds the revenue foregone by limiting the number of lots for sale. In addition, on the cost side, limited development projects potentially reduce infrastructure expenditures for the developer.[47]

Precisely because of their diversity and range of application across individual markets and geographic locales of the Intermountain West, this report does not define Conservation Development in the context of any one specific type of project, development density, or conservation purpose. In general however, the discussions herein will apply to projects and development strategies that preserve a sizeable majority of a tract's total acreage to meet a significant, meaningful conservation objective.

What are the prospects for Conservation Development within the "new normal" in the Intermountain West?

Conservation Development Prior to the Great Recession

Conservation Development as an approach and design philosophy had been adopted at varying levels across the country both prior to and during the recent real estate boom. As was the case earlier with conservation easements, this approach first saw market success in areas where development pressure and land consumption had occurred at the fastest rates. These included high growth areas on the east and west coasts, destination resort areas in the Intermountain West, and the developing edge of major metropolitan areas in other regions.

Across the more rural areas of the region and particularly the Northern Rockies, Conservation Development's successes to date correlate directly to real estate's time tested axiom of "location, location, location." Smaller developers have undertaken the majority of these projects, largely motivated by a personal connection to the land. However, many have suffered from unfortunate market timing, remoteness of location, capital constraints, missed target markets, or some combination of these.

It can be argued that in successful resort area conservation developments to date, the land conservation component has served mostly as a product differentiator to buyers who may have valued it largely as one facet of a more broadly amenitized concept. As developers then sought to apply this approach in more "removed" locales where raw land inventory was both more available and more affordable, they often attempted to include it within high-cost amenity programs supported by expensive annual dues, in order to simulate a resort environment in these areas viewed as more remote to destination locations.

The market, however, was probably still valuing location and proximity to an established recreation destination more than a conservation real estate ownership experience. The high entry price points and costly dues structures required to build and operate their capital intensive amenities and infrastructure often illuminated the advantages of stand-alone ranch properties as a cost-competitive alternative to these more remotely located projects, thus leaving them "in between" markets. This left them unable to achieve the initial sales velocity necessary to launch a successful project.

In addition to these factors, other barriers to Conservation Development's wider adoption have left the potential for this approach largely unrealized. These barriers fall under the following general categories:

1. Market Risk
2. Entitlement Risk
3. Capital Constraints
4. Execution Hurdles

1. Market Risk: Although Conservation Development results in a very different product from conventional development approaches, the two typically compete for the same group of buyers. Although increasingly promoted by planning professionals, encouraged by certain conservation organizations and advocates, and embraced by a pioneering segment of the developer community over the past 10 years, Conservation Development has made market inroads only very recently and on a limited basis in the Northern Rockies. Conservation ethics, shared values, and preserved open space were generally not valued as an adequate substitute for fenced-in ranchette acreage and upscale recreational amenities by the market during the boom.

The realtor community has also typically been slow to understand and accept the viability of this type of development.[48] This often lengthens absorption timelines while requiring developers to allocate more resources to internal marketing programs and broker education. Given that Conservation Developments typically reduce lot yield from a conventional approach and may require increased feasibility study, planning, and design costs up front, developers can ill afford to be constrained with additional cost burdens and elongated sales cycles caused by tentative marketing strategies.

2. Entitlement Risk: Innovation is not typically rewarded in the regulatory process. In most cases, due to their inherent uniqueness and design creativity, Conservation Developments have had to navigate Conditional Use or PUD review processes at the local government level. Planning departments and county commissioners have often required additional education, outside assistance, and uncommon perseverance in understanding how these projects fit within a regulatory framework that never anticipated their motivations, advantages, or benefits. This is particularly true in rural counties with more limited staff resources, and where public concern over changing land use and skepticism toward outsider intentions is also more common.

As most professional developers prefer clear, straightforward, "by-right" approvals versus the additional time, uncertainty, and scrutiny associated with conditional use processes, conventional development alternatives have been their default choice. Larger developers have had to rethink their interest in undertaking a Conservation Development approach when facing questions of an extended and uncertain entitlement process.[49]

3. Capital Constraints: In eastern U.S. markets, limited development projects on smaller parcels have been enabled through funding from the purchase of conservation easements

by a host of conservation organizations, and in some cases facilitated through the acquisition of land by private land trusts.

This approach is rare in the Intermountain West, due in large part to the sizeable acreages typifying ranches and rural properties with meaningful conservation value, and the price points attached to them in demand areas. In addition, land trusts operating in the region have been slow to recognize Conservation Development as an appropriate tool for land conservation. Further, purchased easements that mandate some level of public access to the lands they protect can make management of the open space more difficult and conflict with the desires of prospective buyers.

Even under favorable credit conditions of the boom, conventional development enjoys a substantial advantage in fitting into the array of project classes most recognized by lenders and investors.[50] These projects typically provide a product easily recognizable to the market and fit neatly into established development financing formulas. By contrast, Conservation Development projects have a mixed history of market acceptance, particularly in areas of emerging demand. Debt and equity capital also may assign higher risk to projects by pioneering developers who, while successful in other entrepreneurial ventures, do not have lengthy track records. Thinly capitalized, these projects have had little margin for error and minimal capacity to endure unforeseen entitlement costs, economic slowdowns, or a greater than anticipated market education cycle.

4. Execution Hurdles: Pushing the boundaries of innovation can carry with it the pains and inefficiency of trial and error. In some cases, Conservation Development projects have suffered from poorly set objectives through a misplaced reliance on the prospective tax incentives and perceived financial benefits of conservation easements.

After national media exposure first drew attention to abuses of conservation easements in 2003, the IRS by mid-2004 had issued a public notice stating its intent to more closely examine charitable deductions taken for conservation easement donations. Certain areas of the Intermountain West, most notably Colorado, have since "become a laboratory for IRS audits of conservation easements," as reported by the Land Trust Alliance.[51] This has compounded the complexity and risk associated with applying easements within the development process. Uncertainty associated with this increased complexity and scrutiny has also, in some cases, chilled land trust interest in accepting donated easements associated with a development outcome.

The costs and management implications of the open space in a Conservation Development project can also be a significant hurdle. Costs and resources associated with management of an open space amenity may seem lower in the aggregate than those for more land consumptive, capital intensive recreational amenities, such as golf courses. However, to deliver lower cost ownership, open space must do more than just cost less to implement, offer a market differentiating novelty, or provide a means to financial engineering. It should contribute to the ongoing financial viability of the project.

For example, a 1,000-acre Conservation Development project undertaken on productive agricultural land that configures home sites in a way that leaves 80 percent of its acreage in a sustainable farming or ranching operation will realize a meaningful revenue stream that offsets cost of ownership for its residents. At the same time, the land is managed for its historic use, benefiting its new owners, neighbors, and the surrounding community. Unless investments in green infrastructure and open space amenities can sustain themselves over time, the projects incorporating them will become endangered.[52]

Integrating the built environment within a land conservation objective requires a well-conceived management plan for the open space. Ownership and control of the open space resource dictates the responsibility and structure of these management plans, which must be both clearly understood and deemed plausible by prospective buyers who may, in fact, have a limited frame of reference for evaluating them.

Conservation Development's Prospective Appeal to Re-Emerging Markets

Though often characterized as a pioneering endeavor, Conservation Development's market potential has been proven in the face of the above challenges as new projects have been successfully launched across the Northern Rockies. To be more widely adopted, however, this approach must continue to build consumer awareness with prospective buyers and demonstrate broader market acceptance. The effects of the Great Recession and the boom's collapse may have created more favorable market conditions for this approach.

This report has noted several underlying fundamentals that are likely to affect future real estate market appetites through impacts on future consumer purchasing power. These include reduced household wealth, de-leveraging, credit system contraction, long-term employment instability, and a reduced capacity for major discretionary purchases.

Given changes of this magnitude, it appears that real estate market appetites for the foreseeable future are unlikely to resemble those of the recent past.[53] It is also expected that markets for discretionary second home purchases will remain under pressure, while cost of ownership and "value buys" will become primary factors in a majority of real estate purchases. It is also anticipated that new appetites may emerge, driven by reduced purchasing power, backlash against the boom's excesses, and concerns regarding environmental sustainability. This shift may coincide with appetite changes driven by the demographic fundamentals of an aging population as well.

According to research published by Professor Arthur Nelson of the University of Utah,[54] major demographic changes will shift future housing demand in the U.S. significantly away from recent trends supporting far-flung suburbs featuring detached single-family houses on large lots. As our population ages, and the percentage of households with children drops, demand for homes on smaller footprints and closer to services, retail spaces, and transit will increase. Nelson's research indicates that:

- Between 2010 and 2030, four in five new homes needed to accommodate household growth will be for households without children.
- As much as 75 percent of all households prefer residential units that may support urban features such as transit accessibility and proximity to nonresidential uses.
- Single-person households will surpass households with children by 2030, for the first time in the nation's history.

The foregoing suggests an opportunity may be dawning for Conservation Development as an approach for delivering the right products, at the right places, at the right time to healing real estate markets. By integrating open space that enables lower cost recreational amenities with lot layouts conducive to reduced built footprints and genuine resource sustainability, this approach can meet future mainstream market appeal.

It is worth keeping in mind that the consumer behaviors of the past quarter century are deeply ingrained and memories have often proven short. A robust economic recovery could quickly reinvigorate old habits and preferences, particularly in second home markets. Unforeseen forces driven by influence from foreign investment capital, a substantially weakened U.S. dollar and/or significant influx of overseas buyers could emerge and shift market dynamics at any time. Nevertheless, the aforementioned impacts on the U.S. consumer are compelling factors in anticipating future market behavior.[55]

Real estate preferences under the "new normal" will be driven by more than just a backlash against conspicuous consumption.[56] As recent surveys indicate, the development community is already anticipating shifts in social consciousness and an increased appetite for environmental responsibility. This includes an expected increase in interest in projects including components such as land conservation, community supported agriculture, and alternative energy solutions. How much the market may be willing to pay for these components is as yet unclear; some industry experts estimate the "green premium" may lie somewhere in the 5-percent to 15-percent range.

The collapse of the real estate bubble has shattered much of the belief in real estate as "an investment."[57] This implies that second home purchases will no longer be justifiable on an "enjoy it now and flip it later" basis, while primary residences will be purchased for safety and comfort driven by the need for shelter rather than speculation and the short-term expectation of appreciation gain. This, in conjunction with continued pressures on purchasing power and the need to increase household savings, suggests a new era in which the cost of real estate ownership will matter more.

Results of bankruptcy auctions for both the Tamarack (Idaho) and Promontory (Utah) resort properties held earlier in 2009 are telling. The notable absence of a meaningful number of prospective bidders beyond existing creditors while significant investment capital remains on the sidelines might suggest investor-level concern with concepts that require capital intensive front loading, especially in areas of significant oversupply. An "unwinding" of broken boom-era real estate models may be in the offing. For many of those still able to justify a second home, the future may lie in simpler concepts harkening back to the family "cabin in the woods."

Realizing Conservation Development's Potential in Future Markets

Capitalizing on the convergence of factors that may be shifting market preferences toward Conservation Development can only occur if the past hurdles to successful projects are met. These hurdles include marketing challenges, local government review and approval, capital availability, land trust involvement and effective delivery of a lower cost product. Potential solutions to these hurdles include the following:

<u>Increasing Consumer Awareness and Brand Recognition:</u> The evolution of a common language speaking specifically to direct consumer benefits and beyond the collective goals of sustainability and environmental sensitivity alone is critical.[58] This is also essential to fostering consistency in the communications between developers, builders, contractors, buyers, lenders, and investors that form the narrative defining Conservation Development within mainstream market consciousness. As consumer awareness improves, realtor ambivalence toward these projects will also soften.

<u>Local Government Actions:</u> Local governments can encourage Conservation Development by:

1) Including clear language in their comprehensive plans that Conservation Development is the preferred alternative for rural subdivisions, and clearly spelling out their land protection goals. Greater predictability for developers, conservation advocates, and the public can be achieved by more specifically tying land conservation goals to growth and development-oriented objectives. If comprehensive plans discuss development in the context of conserved land, conservation-oriented projects are more likely to emerge and opposition to development in general will be reduced.

2) Reforming their zoning and subdivision ordinances to reduce regulatory hurdles and provide meaningful incentives for land protection. Minimum lot size rules should be reduced to the size required for safe sanitary purposes, and rigidity in design standards defining road widths, minimum building setbacks and curb and gutter requirements can be reduced. Perhaps most importantly, density bonuses should be granted if certain standards, such as increased open space, are met.

3) Adopting ordinances that allow Conservation Development as a by-right use in residential zoning districts and streamline the review process. Staff should be trained in conservation subdivision design principles, clearly understand the entitlement process for Conservation Development, and be available to assist with the early, conceptual design phase to reduce uncertainty and unforeseen problems in the regulatory process. Finally, the allowable density granted for conventional subdivisions could be reduced if its developers do

not protect a required amount of open space on the site. If a jurisdiction chooses such an approach, the default standard for full density, therefore, would become the Conservation Development design process.

4) Correctly incentivizing for open space by offering flexibility in meeting land protection requirements. Mandating one specific conservation mechanism alone within subdivision regulations can lead to unintended consequences and be self-defeating in promoting Conservation Development. For instance, landowners will, in most cases, lose their donative intent, and therefore the tax deductibility of their conservation easement value when it is required as part of a regulatory approval process. In addition, an organization qualified to hold donated conservation easements must be available; if these easements are specifically "mandated" and local land trusts are unavailable or unwilling to hold them, county governments may put themselves in a difficult if not impossible position of having to fill the void.

   A friendlier and perhaps more constructive environment for Conservation Development can be created by leaving a wider range of options open for developers planning and designing projects to meet emerging target markets seeking open space as an amenity. Beyond conservation easements alone, permanent protection of this open space may be achieved through effective use of CC&R's and other deed restrictions that result in development that meets community growth objectives as well as market demand.

<u>Increasing Roles for Land Trusts:</u> Land trusts are frequently ambivalent toward Conservation Development. These organizations must balance increasing risk in defending conservation purpose for the easements they hold, resources for monitoring increasingly complex easement terms, and consistency with an organizational mission that may seem to be at odds with a development outcome for specific properties.

Despite these ongoing challenges, land trusts seeking to protect their long term role in community land preservation efforts will benefit from proactive involvement in Conservation Development initiatives. A project's market viability is expressly tied to credible long-term stewardship of the conserved land resource. Successful planning for these projects relies on an early and active partnership between the developer and the easement holder. Hurdles in executing these projects can be lowered with greater recognition of this development approach by land trusts as a progressive evolution in land preservation that they can meaningfully influence. Locally based community land trusts may find a more active role in this regard.

<u>Delivering a Lower Long-Term Cost of Ownership:</u> Delivering sustainability and genuine value to buyers through a lower ongoing cost of ownership can differentiate Conservation Development from conventional alternatives. Achieving this will require continued use and refinement of past innovations. These may include non-profit ownership of open space by resident-based land preservation associations, creative mechanisms such as the sale of carbon offset credits, or cooperative agreements with

local agricultural producers that allow open space amenities to generate positive cash flow that offsets expenses within homeowner association budgets.

This approach may present opportunities for developers retooling their business models to meet the economy's new normal. This is particularly true in areas left with a vast oversupply of lot inventory in the boom's wake. As structural oversupply further reduces pricing power for both adequately capitalized as well as distressed development projects in these markets, viable strategies to reduce supply and re-establish value will be sought.

As developers adjust and alter their approach to accommodate shifts in market appetites and tighter lending standards, preference for projects anticipating traditional five- to seven-year sales cycles is likely to harden. Active developers and investor groups seeking emerging opportunities may begin to rethink projects that require substantial capital exposure for the up-front build-out of intensive vertical infrastructure while creating lot inventory well in excess of their market's projected absorption capacity under the new normal. A paradigm focused on reconfiguring obsolete amenity programs and reducing lot numbers from previously approved plats that are no longer viable may be at hand. While an entitlement that maximized physical lot yield may previously have been thought of as adding value and flexibility to a project in a seller's market, it may now be viewed as a headache to unwind and a burden in meeting the market for emerging buyers going forward, and therefore an obstacle to attracting project investment.

Should it become clear that emerging market preferences have shifted from a majority of the existing product remaining in oversupplied markets, new regulatory mechanisms that enable developers and owners of distressed projects to rethink and remake these existing subdivisions may be warranted. These tools, techniques, and processes could creatively support the replatting or vacating of subdivisions where entitlement values have been diminished due to extraordinary oversupply and/or what the market now perceives as obsolete design. A companion Lincoln Institute Working Paper, *Premature Subdivisions and What to Do About Them*, by Don Elliott of Clarion Associates, discusses the planning, policy, and legal issues surrounding the vacating or redesign of existing subdivision plats.[59] At the same time, counties will benefit most by leaving adequate room for the natural self-correcting powers of the market to operate. Given land values that may continue to decrease and remain depressed for an extended period of time, the continued opportunity for private, voluntary mechanisms to clear markets on their own may well outperform government-driven actions.

As the U.S. economy recovers from a severe recession, collapse of a national real estate bubble, and the most significant financial crisis since the 1930s, rural real estate development in general will remain sluggish for the foreseeable future. However, given that prior to the economic crisis innovative Conservation Development projects demonstrated significant potential to meet emerging market appetites, future prospects for this approach appear to be bright.

The eventual mix of development alternatives will vary from market to market as a function of local demand, conservation values of the local landscape, and community growth objectives. By recognizing the strengths, weaknesses, opportunities, and constraints that define their own community appeal and their ability to meet current and future real estate appetites in a manageable way, local government officials can make decisions that help sustain community identity, property values, long-term fiscal stability, and quality of life for both current and future residents.

Conclusion

The Great Recession has left many local real estate markets of the Northern Rockies and the greater Intermountain West reeling and in disarray. Conservation Development can play a unique role in the eventual healing of these markets, particularly those faced with an excessive oversupply of unsold vacant lot inventory. This approach has demonstrated an ability to create the types of products that can meet the market appetites that appear likely to emerge from the national real estate market's collapse, the financial market meltdown that followed, and the severe recession that has ensued.

To date, this approach has most often been applied to rural properties considered to be "in transition" from agricultural or natural resource production to residential or recreational use. Changing economics pressuring farming and ranching operations, along with family succession and estate planning concerns, have been critical factors driving the disposition of these lands, many of which are high in conservation value and have been in family ownership for generations.

These projects have frequently been undertaken as innovations for niche markets by conservation-minded, altruistic developers or reluctant, but capable landowners. In many cases, monetizing these valuable land assets by selling and/or developing all or a portion of them has been the landowner's most viable option in addressing financial needs and family objectives. Early Conservation Development successes have often combined proximity with highly amenitized products at luxury price points that justify the revenue foregone though reducing lot yield. However, in the run up to the boom's collapse, as consumer appetites sought more sustainable options and green paradigms, other incarnations of this approach and their thoughtfully integrated planning and land preservation techniques had begun to demonstrate the promise of mainstream market acceptance outside of the resort arena.

An uncertain environment for financing these projects remains perhaps the biggest near-term impediment to their wider adoption. To this point, pioneering developers and their unique abilities to structure private equity investment have been the primary source of capital for this development approach. Notwithstanding the encouraging gains in market acceptance, a generally reduced appetite for real estate development of all types in both the debt and equity capital markets is likely to be evident for the foreseeable future, as bloated inventory levels depress prices in many markets and financial institution balance sheets remain under stress.

Offsetting these financing hurdles, valuation resets occurring in both the price of raw land and the cost basis of distressed developments will provide the foundation for eventual restructuring of product and pricing to meet returning buyers and their changed appetites. As the economic recovery further unfolds and capacity of the consumer becomes better understood, additional qualitative and quantitative research may be warranted. This research might further investigate depth of demand for specific Conservation Development products applicable to specific local markets, as well as alternative conservation subdivision models that address market appetites under the new normal.

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