Dirt Deals: Why Our Funds Hold Land-Secured Bonds

Insights From the Oppenheimer Rochester® Muni Bond Fund Team

There are, to be sure, wary investors (including some professionals) who worry that “dirt deals”—the bonds whose proceeds finance the infrastructure requirements of new real estate development—are just too complex, too risky and frankly too messy to be worthwhile. At Oppenheimer Rochester, we disagree with this fearful premise and believe our experience and expertise have enabled us to acquire many attractively priced securities that have delivered the tax-free income our shareholders seek.

The fears arise, we suspect, because no two dirt deals are identical:

- Undeveloped land can be transformed into new residential neighborhoods, office parks, mixed-used properties or commercial enterprises.
- Successful land developers all have solid track records, a good sense of what a community wants and will support, well-tended relationships with civic leaders, and significant financial resources—but no two are alike.
- Debt structures can vary from deal to deal and from state to state.

Having a hefty checkbook, while helpful, is certainly not enough when it comes to investing in development projects. Rather, the focus must be on determining whether a bond offering is likely to deliver on its promises and thus provide a reasonable risk-reward trade-off for a fund’s investors.

That’s where Oppenheimer Rochester comes in. We rely on our in-house team of credit experts to evaluate scores of tax-exempt land development deals every year. If we believe that the bonds can help our funds achieve their objectives for highly competitive levels of tax-free income, we will bid on dirt deals. Over the years, we have found that these deals—whether extending a sewer line to serve a proposed housing complex or widening a highway access road to give shoppers a more direct route to a proposed mall—may be very attractive to our funds over the long term. The credit quality of dirt deals often improves over time, and the payments that secure these bonds – Special Taxes and Special Assessments – are on parity with real estate taxes and senior to mortgage payments. This means that property owners, which in tough economic times may include banks that have foreclosed on a mortgage, have a very strong incentive to remain current with their tax payments.
What sets these bonds apart from plain vanilla munis is that the obligor on a dirt deal changes over time. As long as someone—anyone—owns the land itself, the bond must be paid. As can happen with any borrower, payments are occasionally delayed or missed. Dirt deals are structured so that the current landowner, whoever that might be, must fully pay the tax that pays the bondholders and makes them whole.

“We believe these deals—whether extending a sewer line or widening a highway access road—can be very attractive to our funds over the long term. We like that property owners are highly motivated to pay the taxes that pay the bondholders.”

As the following example illustrates, the responsibility for making payments can change hands many times over the course of a project’s evolution.

The ABCs of a Dirt Deal

Bob’s Development Company buys a piece of land and obtains permits to erect residential condos on it. Even if Bob has the vision and expertise that land development requires, no one can safely predict what the future will hold. Bob’s may or may not be able to sell parcels to builders. If Bob’s sells the parcels, the buyers may or may not build the condos. If the condos get built, they may or may not sell.

But somewhere along the way, maybe even before the ground is broken for the first condo, the infrastructure needs to be built out. To subsidize this effort, a Special Tax or Special Assessment may be placed on the land. In effect, this tax covers the costs incurred by the developer of the infrastructure (which may or may not be Bob’s).

The typical tax or assessment:

- Covers the debt service on the outstanding bonds, which must have a face value that’s less than one-third the value of the land.
- Is on parity with property taxes (ad valorem).
- Is senior to the mortgage payments.
- In many states is a fixed amount that is not affected by rising or falling property values.

Who pays the tax? That’s simple. The landowner, whoever that may be at the time the tax bill comes due. Thus, the payment might be made by the developer, various builders, homeowners and even a bank that holds a mortgage after foreclosing on a house. A failure to service this debt is akin to ignoring your property taxes. It won’t be long before the local authorities show up at your door with “failure to pay” notices.

These Investments Can Be Risky

A dirt deal, like most investments, can pose some risks. Market prices, for example, can be affected by payment interruptions. Investors’ biggest fear, it seems, is that a property’s current owner will just walk away. Before the economic downturn of 2007-2009, the default risk on dirt bonds was low.

Here’s why: when a developer or property owner walks away and property taxes, Special Taxes and Special Assessments go unpaid, the abandoned property can be purchased by anyone willing to pay a hair over the outstanding taxes. In exchange for making the tax collector happy, the buyer can acquire land that has some inherent value, various permits that have been secured, all the infrastructure that has been built plus perhaps some finished but unsold structures—all for a small fraction of their original value. The new owner’s tax payments plus any taxes collected on land that has been sold to others will be used to make past, current and future interest payments to the bondholders.
Economic conditions may be a factor in a bond’s performance. During the real estate downturn of 1990-91, for example, the number of defaults among California dirt bonds rose. When the economy picked up, most of these troubled bonds went on to perform well.

In 2008, Florida dirt projects were hit especially hard. The overall slowdown in U.S. construction contributed to longer build-out periods than anticipated for many “dirt bond” projects in the Sunshine State. Despite the difficulties with Florida “dirt bond” projects, which primarily affected Oppenheimer Rochester AMT-Free Municipals and Oppenheimer Rochester High Yield Municipal Fund, we continued to believe in Florida’s attractiveness as a destination: the state’s desirable climate and its approach to income taxes – there are none – would ultimately support a bond recovery there, too. As the United States’ housing market has subsequently strengthened, more investors have seen value in these Florida bonds.

Further, because the entrepreneurial spirit runs deep in this country, there’s often someone willing to try to resurrect a dormant project and see it through to completion. Communities aren’t eager to let a half-built project remain that way and often offer incentives to other developers willing to resume the work.

As bondholders, we much prefer to reach an equitable financial solution than to see a project stagnate for too long. For example, in mid-2010, we participated in an auction on the courthouse steps in Jacksonville, Florida, where we foreclosed on some “dirt bonds” that were financing infrastructure at a small real-estate development. We have since foreclosed on other Florida “dirt projects” when we have believed the decision to be in the best interests of our shareholders.

The Bottom Line
We continue to believe that most of our investments in land development projects will provide favorable levels of tax-free income for our shareholders over time. At Oppenheimer Rochester, we are confident that carefully researched dirt deals belong in our funds’ portfolios. Over the years, we have done our credit homework and acquired many Special Tax or Special Assessment bonds that we believe have attractive yields and structures. As the projects these bonds finance get built and as the number of property owners increases with the sales of individual parcels and buildings, those property owners assume some responsibility for paying the tax. The more taxpayers there are to shoulder a given tax, the less risk the bondholders face.

Another way we try to mitigate the risks of these investments is to buy bonds representing many different builders and developers and many different types of projects at different stages of development. We buy bonds in different geographies and work hard to ensure that our holdings represent a diverse set of maturities, structures and credit ratings, too. In combination, the Special Assessment and Special Tax sectors typically constitute a significant percentage of Oppenheimer Rochester California Municipal Fund’s investments. The two sectors may represent large segments of other Oppenheimer Rochester funds as well. As long-term investors know, our portfolios reflect many sectors and include many different types of securities that have passed our in-house credit evaluations. We believe that the varied nature of our funds’ overall holdings can help mitigate the impact of the risks associated with having significant holdings in these real-estate-related securities.

Lest any of you think that it’s a cakewalk to generate a decent return on a “dirt deal,” please note that the example about Bob’s Development Company is a gross oversimplification. Our in-house team of credit analysts brings significant energy and experience to the process of evaluating these opportunities. We have looked at many different types of deals, worked with many different tax districts and have developed considerable insights into the nuances that make a deal successful. It’s not always a straightforward process, but it’s one that we believe will continue to provide long-term benefits to our shareholders.
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Deterioration of the Puerto Rican economy could have an adverse impact on Puerto Rican bonds and the performance of the Rochester municipal funds that hold them.

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