LESSON 4 - LAND DUE DILIGENCE & LAND FINANCING AND INVESTMENT CHARACTERISTICS

DUE DILIGENCE FACTORS

1. The first concern is with ZONING. Zoning is the key to any land parcel. Zoning can be a tricky issue.
2. The second concern is the AVAILABILITY OF UTILITIES.
3. The third concern is LOCATION INFORMATION.
4. The fourth concern is PROPERTY-LEVEL INFORMATION.

LAND FINANCING AND INVESTMENT CHARACTERISTICS

Most lenders do not like land loans. Land is illiquid and has little to no cash flow. Land investments can usually use cash for years before it generates any cash flow.

For such reasons, lenders do not typically make very aggressive land loans. The typical land loan is only 50 to 65 percent of costs.

To purchase land, buyers must come up with a bigger share of cash than when buying income properties. However, there are ways that buyers can bridge the financing gap when bringing less than 40 percent of costs to closing. In the next section we will review these land financing options.

LAND FINANCING OPTIONS

The first is the SELLER CARRY-BACK. It is very common for the seller to finance a portion of the sale. This is known as seller carry-back or seller take-back.

The second financing option is the INSTALLMENT SALE. This method involves paying for the land over time.

The third financing option is the LOT OPTION CONTRACT. A lot option contract, also known as the farmer option, involves a small down-payment with a long lead time to close.

The fourth option is the SELLER JOINT VENTURE. In many cases, the seller might partner with the developer and "contribute the land" to the deal, as an equity investment.

PURCHASING LAND

Land can be purchased through a variety of methods. The first method is the CASH CONTRACTS. The cash contract is the simplest and easiest method. The buyer pays cash at the closing to own the land.

The second method is OPTION CONTRACTS. These contracts are typically used to buy a piece of unimproved land. The buyer provides a small, non-refundable down payment and has time to pay for the rest of the land.

The third method is an INSTALLMENT CONTRACT. With this contract, the buyer owns the land at closing and can develop it as intended.

STRUCTURING THE LAND ACQUISITION TRANSACTION

SELLER CARRY BACK

It is very common for the seller to finance a portion of the sale. The seller may finance the majority of the land, by requiring a 10-20% down payment, **or may take a second trust loan, subordinate to the first trust loan**. Key points are:

- Interest rate.
- Amortization.
- Term (should be co-terminus with the first trust loan).
- Personal recourse.

LOT OPTION CONTRACT

Farmer Option:

A **small down payment with a long lead time to close**, with closing based on time **or achieving an objective** (i.e. re-zoning).

INSTALLMENT SALE

Paying for the land over time. The deed is transferred to the buyer, subject to monthly, quarterly, or annual payments to retire the debt.

This is a form of selling financing. The payment is an installment sale which will amortize the balance to zero.

TRADITIONAL BANK DEBT

During strong economic times, most **local, smaller and regional community banks** will make recourse, low-leveraged land to qualified borrowers on approved / entitled land.

MEZZANINE LOANS

Depending on the development and economic climate, some opportunistic lenders will provide mezzanine loans on land

They will typically go up to 80% of the capital structure.

PREFERRED EQUITY

Private investors may make a preferred equity investment on land. They will typically go up to 90% of costs.

EQUITY

There are **few** land players in equity. They will take a large percentage of the deal and will typically go up to 95% of costs.

SELLER JOINT VENTURE

In many cases, the seller of the land may partner with the developer and will "contribute the land" to deal as an equity investment. In these cases, the partners need to:

Establish a Value For The Land Being Contributed

This can be done through an appraisal or through the residual analysis method.

Establish a Profit Participation Structure

The seller (equity investor) and the sponsor **must develop a profit sharing structure based on the land contribution and the developer's contrbution.**

ESTABLISHING THE VALUE OF LAND

Land value can be difficult to establish. Traditional appraisal methods include the following:

SALES COMPS compare the prices that the investor pays and the price that other have paid for comparable properties in similar markets. There are several issues with this approach. The first issue is that all land is different and unique. Land differences include submarket location, soil conditions, and development costs. The second issue is that these factors are difficult to sort through and create a direct comparison.

AS-IS, WHERE-IS VALUE is the value that the land would sell for now.

BULK SALE VALUE is the amount of a sale to a wholesaler rather than to a developer. This price allows for a wholesale profit and a retail profit.

DISCOUNTED CASH FLOW VALUE assumes that the property is developed over a long-term time horizon (typically 10 years) and discounted back to present. Key variables include the following: