ACPARE

LAND DEVELOPMENT:

OPPORTUNISTIC TRANSACTIONS

WHAT TO EXPECT / COURSE OBJECTIVES

1. Explain the key metrics used to value land.
2. Discuss how to conduct land due diligence.
3. Create a plan for structuring a land deal.
4. Compare and contrast land uses and the most profitable land types.
5. Conduct residential and commercial residual analyses.

LESSON 1 - START HERE

TYPES OF COMMERCIAL REAL ESTATE TRANSACTIONS

STABILIZED PROPERTIES

- Permanent financing
- Fully leased with rents at market rate and current cash flow within the properties
- No more work to be done on the property to “grow or groom” the NOI
- Lenders are betting that nothing “bad” will happen to the project cash flows in the future

TYPES OF COMMERCIAL REAL ESTATE TRANSACTIONS

UNSTABILIZED OR VALUE-ADDED PROPERTIES

- Shorter term or floating rate financing
- Not fully leased, and/or rents are not at market
- Substantial work to be done before the property becomes stabilized
- Something “good” needs to happen to the property cash flow in order to stabilize the property and achieve the business plan objectives

TYPES OF COMMERCIAL REAL ESTATE TRANSACTIONS

OPPORTUNISTIC PROPERTIES

- These properties typically require “specialized” financing.

THE TOTAL COMMERCIAL REAL ESTATE STRATEGY

3 ASSET ARBITRAGE
("Crossing Trades", Wholesaling)

- Making incentives and fees net of the bid.
- Most commonly single commercial assets and Bulk REO/Non-Performing Residential Loan Portfolios.
- "Building the Book": Find out the axe of your Bulk REO/NPL buyers and cross smaller trades from a larger institutional seller or bank to smaller but qualified buyers.

2 CAPITAL FORMATION
("Principalling" or Syndication)

- Raising debt or equity to buy commercial real estate assets - ideally assets with assumable loans ("conduit loans").
- Advising others to raise equity capital and creating their pitchbooks for you to invest alongside them ("real estate investment banking").

1 CAPITAL PLACEMENT
(Financing Deals)

- **Providing Debt, Mezzanine** ("Mezz", "Pref") or **Preferred Equity** ("Pref") **Capital**
- **Credit Facilities** (Bulk REO Buyers, Hard Money Lenders)
- **Debtor-In-Possession Financing**

THESE WILL USUALLY FALL INTO TWO BUCKETS:
1. Real estate investors who have found something interesting to buy but don't have all the capital they need
2. Commercial owners who have been asked "buy their note back at a discount"; meaning that they have the opportunity to refinance their note for lower than the current unpaid principal balance ("UPB").

HOME THE BASIS

- Any deal requires you, your investors or your buyers to get in at a strong basis (low purchase price as compared to value of asset **today**).
- The basis will either make or break the deal, **and your reputation as a deal maker.**
- Deals with the lowest possible basis are technically home runs.
- For Commercial: Use the "5 Data Points" to qualify these deals and determine your basis at bid.
For Bulk REO/NPL: Use pricing expectations from your seller.

DEAL FLOW

- You will not know or really be able to control the types of deals being thrown at you due to the nature of the real estate business.
- Your job - **and where you add the most value** - is determining if you're going to hit a "single", "double", or "triple".

SPONSOR AND SPONSORSHIP EQUITY

Sponsor equity is also known as “skin in the game.” The investor should not that not all sponsor equity is created equal!

1. The good investor will know the sponsor’s sources of equity. The first is cash equity.
2. The second equity type is market equity.
3. The third equity type is syndicated equity.
4. The fourth equity type is large investor or limited partner equity.
5. One final factor to consider for equity transactions is debt equity.

SPONSOR AND SPONSORSHIP EQUITY

THE SPONSOR, OR OWNER/OPERATOR, IN A COMMERCIAL REAL ESTATE TRANSACTION NEEDS TO BE SUITABLY QUALIFIED IN THE FOLLOWING AREAS:

CAPITAL: Have sufficient capital to co-invest in the transaction

INFRASTRUCTURE: Have the appropriate organization to take on the project

CONSTRUCTION: Be qualified to manage the construction needed to rehabilitate the property

MANAGEMENT: Be qualified to manage or oversee the day-to-day operations of the property

LEASING: Be qualified to oversee the leasing effort

STAYING POWER: Have sufficient net worth to support the property if unexpected costs overrun the budget or delays occur.

SPONSOR AND SPONSORSHIP EQUITY

THE KEYS TO SELECTING THE RIGHT SPONSOR	GUIDELINES FOR SPONSOR CO-INVESTMENT AMOUNTS
The sponsor, or owner / operator, in a commercial real estate transaction needs to be suitably qualified in the following areas:	**5%** **CO-INVESTMENT:** Not very desirable, as it creates an "option value" for the sponsor. Any investor who accepts a 5-percent co-investments would be well advised to make up for this low investment amount with additional structure.
INFRASTRUCTURE: Have the appropriate organization to take on the project	**10%** **CO-INVESTMENT:** Marginal; must have "going-in" merits that make the probability of success high.
CONSTRUCTION: Be qualified to manage the contruction needed to rehabilitate the property	**15%** **CO-INVESTMENT:** Normal and acceptable; a good starting point.
MANAGEMENT: Be qualfied to manage or oversee the day-to-day operations of the property and tenant marketing plan	**20%** **or MORE CO-INVESTMENT:** Indicates a sponsor who truly believes in the asset and business plan.
LEASING: Be qualified to oversee the leasing effort	
STAYING POWER: Having sufficient net worth to support the property if unexpected costs overrun the budget or delays occur.	

LESSON 2 – LAND OVERVIEW

LAND TYPES

There are seven main types of land that we will review in this lesson.

The first is RAW, UN-ENTITLED LAND. This land is typically farmland or agricultural land and is considered the most basic form of land.

The second land type is MASTER-PLANNED RAW LAND. Municipalities generally have a master plan for their communities.

The third type of land is ZONED RAW LAND. Zoning defines the types of use that might be permitted on the land.

The fourth type of land is PRELIMINARY-APPROVED RAW LAND. The land is zoned, has gone through the necessary public hearings for subdivision or a site plan, and is approved for the intended use.

LAND TYPES

There are seven main types of land that we will review in this lesson.

The fifth type of land is FULLY APPROVED RAW LAND. Approved land, or "paper lots," provides real value to the owners.

The six land type is APPROVED AND FINISHED "SUPER PADS." These larger, finished tracts or pads are fully graded with all utilities functioning up to the site.

The final land type is APPROVED AND FINISHED LOTS. These are the ultimate land commodities. Finished lots mean that the land has been graded and public utilities and roads are in place.

SAMPLE TRANSACTION – RESIDENTIAL LAND

ASSUMPTION FOR A 50-LOT RESIDENTIAL LAND ACQUISITION

		PER UNIT
Purchase price (including closing costs):	$3,000,000	$60,000
Development cost:	$2,750,000	$55,000
INTEREST RESERVE:	$414,000	$8,280
TOTAL CAPITAL STRUCTURE:	**$6,164,000**	**$123,280**
Loan request:	$4,623,000	$92,460
Total equity:	$1,541,000	$30,820
Construction cost:	$17,000,000	$340,000
Average home value:		$600,000

SOURCES AND USES OF FUNDS

SOURCES OF CASH	AMOUNT	PER ACRE
Equity:	$4,623,000	$184,920
Loan:	$1,541,000	$61,640
TOTAL:	**$6,164,000**	**$246,560**

USES OF CASH	AMOUNT	PER ACRE
Acquisition costs:	$3,000,000	$120,000
Rehab costs:	$2,750,000	$110,000
Interest reserve:	$414,000	$16,560
TOTAL:	**$6,164,000**	**$246,560**

SAMPLE TRANSACTION – COMMERCIAL LAND

Similar the residential land example, in this example, the greatest concerns are the purchase price and the development cost of the land.

However, other considerations need to be evaluated as well.

Unlike residential land that will likely be sold off to the individual consumers, commercial land will likely be leased to the tenants. You have likely seen the “build to suit” signs when commercial land is for sale.

In many instances, the investor/developer will build for the potential tenant and then lease the property at a certain amount.

This is usually determined in a lease rate of per square foot. Some of the considerations that are made for the pricing include location, competitors in the same area, and the need for the additional space.

THE LAND CONTINUUM

LEVEL	1	2	3	4	5	6	7
Land Status	Raw	Raw	Raw	Raw	Raw	Finished Super Pads	Finished
Approval Status	Agriculture Land	Master Planned	Zoned	Preliminary	Approved Entitled	Approved Entitled	Approved Entitled
Comment	All land starts as agricultural land by default	The municipality has overlaid general concepts for land use.	The specific property land use has been determined.	Public hearings approved general concepts.	Significant value has been created. Land has "achieved transferable development rights".	Valuable land. Finished lots have all utilities. No roads, but ready for development.	Finished lots are ready to build. A land commodity.
Capital Formation	Value as farm land. Financed based on crop output. Taxed as agricultural land at very low rates.	Financed as farm land, interim use or speculative future value.	When zoned, it is taxed as vacant land, at the same assessment rates as commercial property. Financed from cash flow as interim use or on a speculative basis of future use. Early equity capital seeks returns at 30% plus IRR. Debt is based on future value with credit support.	When zoned, land is taxed as vacant land, at assessment rates as commercial property. Finance from cash flow on interim use or on a speculative basis of future use.	Project is preparing for development. Terminating interim land use. Equity capital is more available. Bank financing is now possible.	Project is ready for vertical construction. Construction financing is available. Equity is plentiful.	Project is now a community. Most liquid stage of asset class. Debt/equity is plentiful.

LAND BASICS

The first type is RESIDENTIAL. Residential land is approved for unit housing, including single family homes, townhomes, cooperatives, and condominiums.

The second land transaction type is COMMERCIAL. Commercial land is approved for income-producing property, such as retail, hotel, office, industrial, or condominiums.

The third land transaction is MIXED-USE. Mixed-use land is approved for both residential and commercial. This land is the most difficult to analyze since there is not one clear path that could be taken.

LAND INVESTING CHARACTERISTICS

The first characteristic is ILLIQUID. Land is the most illiquid of all real estate investments and the market for land sales is significantly smaller when compared to retail, office, industrial, and multifamily investments.

The second characteristic is NO CASH FLOW. Land investments provide little to no cash flow (e.g. parking lots, lots for temporary uses, such as Christmas tree sales).

The third characteristic is CASH REQUIREMENTS.

The fourth characteristic is MARKET-DEPENDENT VALUE. Market conditions affect land values amore than any other asset class.

The final characteristic is TERMINAL VALUE ONLY. Unlike commercial real estate, land does not provide an income stream. The cash-on-cash return comes at the time of sale.

LAND INVESTMENT STRATEGIES

There are two main strategies for land investing. The first strategy is BUY LAND AND CHANGE THE APPROVED USE. This approach generally has a large positive impact on the land values.

The second strategy is ACQUIRE AND SUBDIVIDE LARGE PARCELS. Subdivide larger parcels into smaller parcels. This strategy creates a zero basis in the remaining land and provides for instant equity in the remaining parcels.

LAND BY THE NUMBERS

1. Per Acre
2. Dirt Square Feet
3. Buildable Square Feet
4. Floor Area Ratio Square Feet
5. Lots
6. Land Conversion

LESSON 3 - LAND, POLITICS, AND RISK

LAND RIGHTS

The first land right is that LAND RIGHTS FORESHADOW FUTURE GROWTH. Land zoning and approvals that dictate the future character of an area are known and land use policy.

The second land right is that LAND USE IS DRIVEN BY LOCAL MUNICIPALITIES. Examples of wide-ranging land use policies include Berkley, CA and Boulder, CO.

The third land right is that LAND INVESTORS PAY MORE ATTENTION TO LOCAL POLITICS.

The fourth land right is that LAND USE ISSUES LEAD TO BROADER DEMANDS ON LOCAL INFRASTRUCTURE.

LAND DEVELOPMENT RISK

The first is the APPROVAL RISK. This risk is locally driven. Approvals are determined by a local municipality, such as a county, city, or town. This risk is the most politically charged when seeking approval for changed or new use.

The second risk is DEVELOPMENT RISK. This risk comes from converting raw land into finished lots. The key issues here are engineering, dirt moving, drainage, cut and fill, and soil conditions.

The third risk is MARKET RISK. This risk comes when the land or lots must be sold into the retail or wholesale markets. Risk factors include the overall U.S. economy, local supply and demand conditions, the availability of debt and equity capital (capital markets), and consumer psychology.

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:

LESSON 5 - LAND DEVELOPMENT ISSUES AND LAND VALUATION

DEVELOPMENT ISSUES

1. Land Title
2. Title insurance
3. Easements
4. Dirt
5. Earthquakes
6. Rock
7. Environmental Issues
8. Endangered Species

DEVELOPMENT ISSUES

1. Wetlands
2. Flood Plain
3. Water
4. Sewer Access
5. Road Access
6. Topography
7. Spike strips
8. Conditions to Approval

INTERIM LAND USES

Sometimes, an investor wants to purchase land that is not fully ready for development. The investor might believe that the property and surrounding area has growth potential and needs to be held until full value is achieved through a proposed development.

In such cases, the investor can seek interim land uses to defray the costs of holding the land.

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