

Chapter 23

Development: The Dynamics of Creating Value

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Development Defined

Development: The continual reconfiguration of the built environment to meet society's needs

- A necessity for society
 - Needs for shelter
 - Needs for working space
- Constant social change implies constant alteration of built environment

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Occasions for Development

- A use in search of a site
 - New locations for expanding franchise
 - Need for a new school
- A site in search of a use
 - Raw land in path of urban growth
 - Land adjacent to new freeway intersection
- Resources in search of an opportunity
 - Pension fund with money to invest
 - Private investor looking for high-yield investment

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Process of Development

1. Establishing site control
2. Feasibility analysis, refinement, and testing
3. Obtaining permits
4. Design: Architect and other professionals
5. Financing
6. Construction
7. Marketing and leasing
8. Operation

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1. Establishing Site Control

- Land is the entry ticket: No site? No development
- Wide differences in access to land
 - Land already owned: Farms on edge of development; ranches near large cities (e.g., Irvine Ranch south of Los Angeles); railroad and timber company land
 - Land assembled for specific purpose:
 - Difficulty of land assembly often justifies government involvement in urban renewal
 - Assembly of land for Walt Disney World

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1. Establishing Site Control (continued)

- Options an important tool for land acquisition
 - Option: Right (not obligation) to purchase in future by a certain date, at a predetermined price
 - Terms depend on relative bargaining strength of buyer and seller
 - Contract for deed: An implicit option
- Joint venture: Landowner puts land into development in return for share of profits
 - Joint venture with future tenant
 - "Build-to-suit" on buyer's or tenant's land
- Ground lease eliminates land cost (e.g., Rockefeller Center)

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4. Design: Other Professionals

- **Land planner:** Creates development layout or “map”
 - Many objectives and constraints
 - Must coordinate inputs from others: Hydrologists, marketing consultants, soil engineers, archaeologists
- **Landscape architect:** Shapes topography, soils, vegetation, and other objects around a structure to harmonize with and enhance it

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4. Design: Other Professionals (continued)

- **Engineers**
 - *Soil engineer:* Determines specifications to achieve safety and stability for structure’s foundation
 - *Structural engineer:* Determines the requisite supporting “skeleton” for a structure
 - *Mechanical engineer:* Determines specifications for HVAC and other building systems
 - *Electrical engineer:* Designs power source and distribution system
 - *Civil engineer:* Designs on-site utilities, streets, parking, and site grading

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5. Financing

Development has a sequence of financing needs

- A. Land acquisition and preconstruction
- B. Construction
- C. Gap or “mezzanine” financing
- D. Postconstruction

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5. Financing (continued)

A. Land acquisition and preconstruction costs

- Cost of the land
- Preconstruction costs (“soft costs”): Title examination; feasibility analysis, market research and testing, permitting process (legal and architectural fees)
- Typical dilemma: Developer faces capital constraint, but banks and other institutions are reluctant to lend on asset with no cash flow
- Solutions
 - Use of option, contract for deed, joint venture with landowner or future tenant, build-to-suit arrangements
 - Use of equity partners

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5. Financing (continued)

B. Construction Financing

- Covers cost of land; soft costs; hard costs
- Typically from a bank
- Floating rate (over prime rate or LIBOR)
- Less risky than acquisition financing: No title, environmental or ecological risks; permits all in hand
- May require “takeout commitment” for riskier projects
- Repaid in stages as construction progresses on basis of invoices for construction costs or by degree of completion

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5. Financing (continued)

C. Mezzanine debt

- Problem: Banks usually lend only 70 – 80% of construction costs
- Developer may seek high-interest-rate debt to fill gap
 - Can be second mortgage debt
 - Often secured instead by pledge of ownership shares
- More expensive than first mortgage construction debt, but cheaper than equity financing

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5. Financing (continued)

D. Postconstruction financing

- ❑ Usually pays off construction debt shortly after issue of certificate of occupancy
- ❑ Funding may be in stages:
 - "Floor loan" for part of full amount until a certain occupancy or other conditions are achieved
 - "Gap" or mezzanine financing may be used until requirements for full loan are reached

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5. Financing (continued)

D. Postconstruction financing (continued)

- ❑ Miniperm loan
 - Combines construction loan and short-term postconstruction financing
 - Allows project to achieve a "track record" of operations
 - May extend for two or three years beyond completion of construction
 - Enables developer to seek better terms for the final ("permanent") financing

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Risk Stages of an Income-Producing Property and Four Alternative Financing Sequences

Construction Period	Lease-up Period	Stable Operations
Construction Loan with Take-out Commitment	Risky Permanent Loan	
Construction Loan with Take-out Commitment	Mezzanine Loan	Safe Permanent Loan
	Floor Loan	
Open-Ended Construction Loan		Safe Permanent Loan
Miniperm Loan		Safe Permanent Loan

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6. Construction

Construction is a complex organizational problem with dozens of subcontractors and hundreds of steps

- **General contractor:** Oversees, controls project
 - ❑ Selects subcontractors (often subject to requirements of developer or architect)
 - ❑ Establishes schedule and sequence
 - ❑ Compensation by fixed-price bidding, cost plus fee, or maximum cost plus fee (cost overruns shared with developer)

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6. Construction (continued)

- **Construction manager:** Liaison and representative of developer during construction
 - ❑ Monitors project
 - ❑ Stands in for developer in discussions between general contractor and architect
 - ❑ Stands in for developer for decisions about "change orders"

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6. Construction (continued)

- **Design-build:** A construction arrangement where architect and general contractor are the same
 - ❑ Aims to reduce needed changes
 - ❑ Makes changes less costly and time consuming since they are within one firm
- **Fast-track construction:** Actual construction begins before design is complete
 - ❑ Speeds up completion
 - ❑ Can be very costly if early design steps are flawed

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7. Marketing and Leasing

- Marketing normally is carried out by an “outside” broker
- Choice is important:
 - Must have presence in relevant markets
 - Must not be marketing competitive properties
 - Must be genuinely enthusiastic about the property
 - Must have relevant expertise
 - Should be involved in original design to offer advice and establish “buy-in”

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7. Marketing and Leasing (continued)

- Advertising and public relations for the property is important
 - Draw attention to the property with events:
 - “No surprise” policy: Be first to inform officials of problems and proposed solutions
- Timing of marketing depends on property type
 - Preselling important for condominiums and commercial property
 - No marketing of apartments until ready for use

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8. Operation

- Begins when property is substantially occupied
- Effective management is important to maintain and increase value

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Typical Development Sequence

Construction Period	Lease-up Period	Stable Operations
Construction Loan with Take-out Commitment	Risky Permanent Loan	
Construction Loan with Take-out Commitment	Mezzanine Loan	Safe Permanent Loan
	Floor Loan	
Open-Ended Construction Loan		Safe Permanent Loan
Miniperm Loan		Safe Permanent Loan

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The “Numbers” of Development

- From the start, the project must “pencil out,” that is, have a positive estimated *NPV*
- The developer explicitly or implicitly watches estimated *NPV* at every decision point
 - Must understand costs
 - Must have good sense of future cash flows

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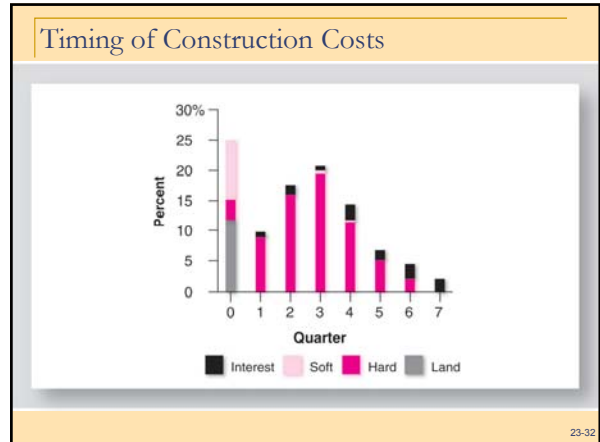
Components of a Construction Budget

- Land costs: Purchase price, interest carrying cost, real estate taxes
- Hard costs: Materials, labor, subcontracts, permits, security, contingency, other
- Soft costs
 - *Construction*: Architect, engineering, insurance, testing, utility fees, permitting costs
 - *Marketing*: Marketing and feasibility studies, title insurance, furnishings for show units, advertising and public relations
- Construction interest
- Developer’s fee

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Example Numbers: 500-Unit Quality Suburban Apartment Project

Land costs		11.9
Hard costs		66.3
Soft costs		11.0
Construction	9.4	
Marketing	1.6	
Construction interest		10.2
Developer's fee		1.7
Cash flow from operations		-1.0
Total		100.0%



- Being a Developer
- What is it like?
- Highly visible accomplishments and impact on the community
 - Financial rewards
 - A "sport" with few protections or rules
 - Great financial risk – described by many as a financial and wealth roller coaster
 - Constant need to influence others by negotiation

- Being a Developer (continued)
- What does it take?
- Strong self-assurance
 - Capacity to manage under stress and uncertainty
 - Creativity
 - Drive
 - Flexibility
 - Vision
 - Capacity to establish credibility and to lead
 - Control of at least one of three components of development: Land, money, or expertise

End of Chapter 23