

Fin 5413: CHAPTER SIXTEEN

FINANCING PROJECT DEVELOPMENT

Adapted from: Ling & Archer: Real Estate Principles, Chp 24

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

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

Real Estate Development

- Development and Construction Business
 - Land development (horizontal development) is the process of changing raw land into a usable building site (parcel)
 - Building development (vertical development) is the process of constructing improvements on a developed site

Types of Developments

- Single family subdivision (often called horizontal development as developer will sell finished lots to the builders).
 - Must project lot selling price, and "takedown" which is the rate at which builders will purchase the lots. Can then work backward to what you can pay for land. (A so called "back door feasibility analysis", as opposed to a front door feasibility analysis which determine the price you need to be able to sell your lots for)

Commercial Property Development

- Multifamily
 - Apartments or condos
- Office
 - Small or large, different classes (A, B, C)
- Industrial
 - Distribution
 - Manufacturing
- Retail
 - From strip center to regional shopping mall

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

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

1. Establishing Site Control

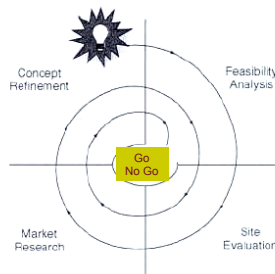
- Options: an important tool for land acquisition
 - Option: Right (but not obligation) to purchase in future before a certain date, at a predetermined price
 - Terms depend on relative bargaining strength of buyer and seller
 - Contract for deed: An implicit option
- Joint venture: Landowner puts land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

2. Feasibility Analysis, Refinement, and Testing

- Financial feasibility question: Does the value, when built, exceed the cost?
 - An application of net present value
- Three possible feasibility outcomes
 - "Slam dunk": Go ahead
 - No go: Move on, don't look back
 - In between: Obtain more information and refine analysis
 - More cost analysis
 - Market research

2. Feasibility Analysis, Refinement, and Testing

Exhibit 24-1: The Cycle of Evolving a Project



RL Worth HQ as Example

2. Feasibility Analysis, Refinement, and Testing

- Tests and surveys that may be necessary:
 - Soil tests (load bearing capacity, drainage)
 - Environmental tests
 - Critical habitats (Endangered Species Act)
 - Hydrological tests (runoff and water flows)
 - Seismic tests (earthquake vulnerability)
 - Archaeological (prehistoric ruins)

3. Obtaining Permits

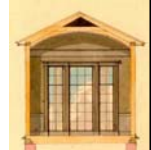
- Multiple layers of permits may be needed
 - Site plan review Environmental impact review
 - Zoning change Regional impact review
 - Land use plan revision
- Site plan review: An inevitable hurdle
 - Complex set of issues
 - Rules and criteria involve interpretation by authorities
 - Neighbors usually resist change
 - Negotiation is critical skill: Important to building support of authorities and citizens in advance
 - Negative decision can kill a project in one meeting



4. Design – The Architect

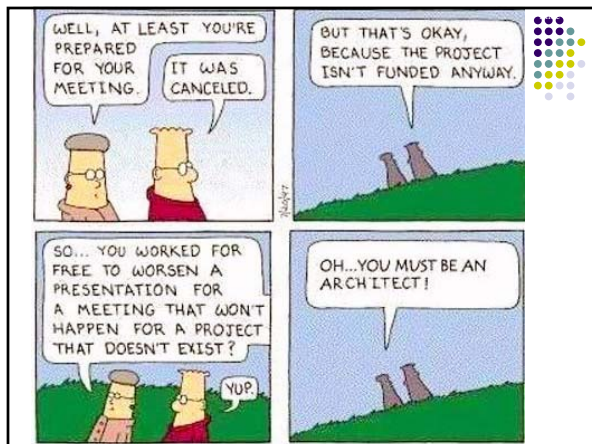
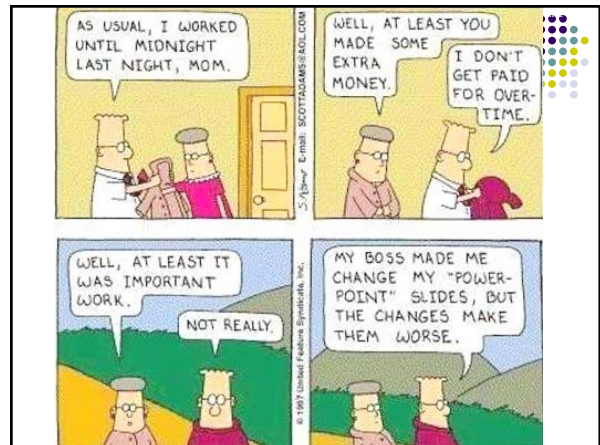
Range of possible roles

- Represent developer in hearings for permits
- Provide predesign schematics of user functions and resulting spatial interactions
- Provide complete design: Detailed design of structure and its systems; detailed working drawings for contractors; procedures and rules for subcontractor bidding
- Serve as project manager



4. Design – The Architect

- Method of compensation
 - Hourly fee (for predesign services)
 - Percentage of construction cost
 - Fixed fee
- Criteria for selecting architect
 - Relevant experience
 - Reputation
 - Goals compatible with developer
 - Able to communicate with developer
- Natural stress between architect and developer
 - Developer is cost and time oriented
 - Architect is aesthetics oriented



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



4. Design – Other Professionals

- 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



5. Financing



Development has a sequence of financing needs

- A. Land acquisition and preconstruction
- B. Construction financing
- C. Gap or "mezzanine" financing
- D. Post construction financing

5. Financing (continued)

- A. Land acquisition and preconstruction costs
 - Land acquisition cost: 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 (developer provides expertise)



5. Financing (continued)

- B. Construction Financing
 - Covers cost of land; soft costs; hard costs
 - Typically from a local bank who will monitor project
 - May require a "take out" commitment
 - Floating rate (over prime rate or LIBOR)
 - Less risky than acquisition financing: No title, environmental or ecological risks; permits all in hand
 - Must ensure that contingencies for the permanent loan are being followed (such as construction quality and timeliness)



5. Financing (continued)

- B. Construction Financing
 - Payments made in stages as construction progresses on basis of invoices for construction costs or by degree of completion less any holdback
 - Loan disbursements – typically made monthly
 - Developer requests monthly draw based on work completed
 - Bank verifies work (may hire a specialist for this) then makes payment
 - Contractors and subcontractors verify they have been paid so as to not place mechanics liens
 - Loan payoff – the loan is paid off from the permanent loan. P&I payments will then be made as agreed from the CF's the property generates



5. Financing (continued)

- C. Mezzanine debt
 - Problem: Banks usually lend only 70 – 80% of construction costs
 - In place of equity to fill gap, developer may seek high-interest-rate debt
 - 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



5. Financing (continued)

- D. Post construction 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

Floor Loan

- initial funding of a [construction mortgage](#) that a lender agrees to advance without regard for tenant leasing, or requiring the builder to substantially complete the project and have a certificate of occupancy. For example, the lender may fund 80% of the total cost of a project, with the remainder, called a [holdback](#), held aside until the builder has leased the majority of units or has the building ready for occupancy. A floor to ceiling loan, in contrast, has two separate fundings: one at satisfactory completion of the project, and a second funding when the building is fully occupied or meets cash flow requirements set by the lender.

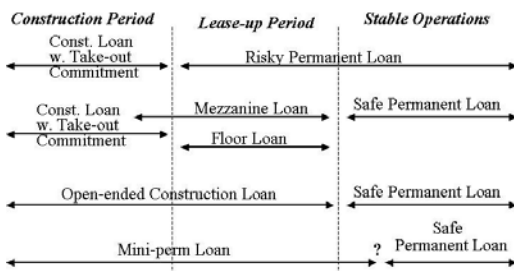
5. Financing (continued)

- D. Post construction financing-continued
- Miniperms loan
 - Combines construction loan and short-term post construction 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

Contingencies for Permanent Loan Commitment

- Period for developer to get construction loan
- Completion date for project
- Minimum lease up requirement and approval of major leases
- Provisions for gap financing if needed
- Expiration date for commitment and provisions for extensions
- Approval of design changes and substitution of materials used in construction

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



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)

6. Construction

- **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”

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

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”

7. Marketing and Leasing

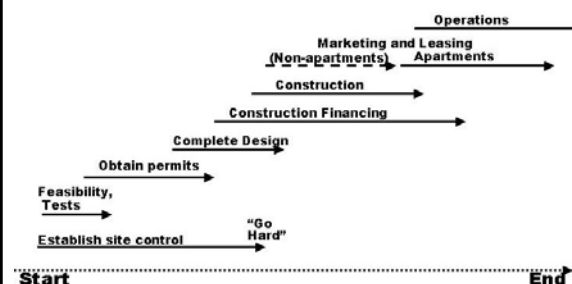
- Advertising and public relations for the property is important
 - Draw attention to the property with events:
 - “No surprise” policy: Be first to inform officials of problems and proposed solutions
- Timing of marketing depends on property type
 - Preselling important for condominiums and commercial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

8. Operation

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



Typical Development Sequence



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

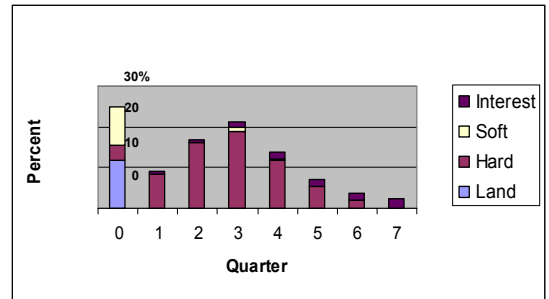
Components of a Development Budget

- 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

Pct Cost Ex.: 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%

Timing of Costs



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? (must sell your project)

- Strong self-assurance
- Capacity to manage under stress and uncertainty
- Creativity
- Drive (Tenacity to endure cycles)
- Flexibility
- Vision
- Capacity to establish credibility and to lead
- Control of at least one of three components of development: Land, money, or expertise

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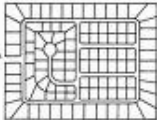
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