

Caution: Replanning Ahead

In their rush to fix broken land plans, developers and cities must proceed with care.

By Barry Gross

The land development industry and local government agencies have both been driven to the edge of an economic cliff by the worst housing collapse in memory.

New development has dried up, and along with it the reliable stream of fees and taxes that funded many local government operations. Projects are stalled, companies are going bankrupt and cities are slashing budgets and vital services.

With the outlook so grim, there is much talk about developers and local planning agencies making a leap together into the realm of fixing so-called "broken" land plans. These are projects that are no longer viable in today's market and that will be even more outdated in the future market to emerge from the ruins of the crash.

If they proceed carefully and intelligently, the two partners can position their projects and their government jurisdictions for greater profitability and fiscal health when the turnaround eventually comes.

But before making this leap and spending large amounts of money in the re-planning process, both sides absolutely need to understand all of the variables and constraints that determine a development's success.

These constraints include planning, economic, market, physical, geotechnical,

environmental and legal costs. Once these constraints are understood, the development team should prepare economic models to optimize the land residual value. After an optimal product mix is determined, then and only then, should land planners begin the redesign efforts.

If the constraints are not well understood, the development team may design a project that looks good on paper but has a lesser chance to achieve economic success. The developer may receive entitlement to build a project that is approved by the local

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jurisdiction but will not be constructed because lenders are unwilling to support it.

And that outcome is bad for both the developer and the local government.

Let's look at just a couple areas of re-planning that are fraught with complexity: Lot size and, correspondingly, lot count.

Recently, there has been significant discussion about redrawing existing projects with smaller lots and smaller houses. Many existing projects that are currently projected to be unprofitable were designed based on market studies prepared more than five years ago when the market was overheated.

At that time, the overriding consideration was that bigger houses would provide bigger

profits. These market studies were supported by lending policies that made mortgages easy to obtain.

The trend toward larger homes was further driven by land planning policies of local jurisdictions requiring minimum lot sizes of as much as 7,200 square feet for single-family detached houses.

To be competitive, developers had to plan larger houses on these larger lots to support the costs that were embedded in local requirements for subdivision approval. Those included high development impact fees and high costs of extending utilities and streets to the newly designed neighborhoods.

Beyond that, many cities imposed standards such as requiring that all lots must be enclosed by masonry walls that added and incremental cost of anywhere from \$3,000 to \$5,000 per home site.

So it's tempting – and smart – to consider changing such plans and requirements to bring down the cost to the developer as well as the consumer. But it should not be done without a full understanding of the complex cost structures involved.

In one California jurisdiction, for example, certain impact fees are determined independent of the size of the house to be constructed. The cost of a sewer connection and a water connection are \$6,000 and \$5,000 per unit, respectively, regardless of the size of the unit.

The total impact fees in this jurisdiction for a 1,000-square-foot single-family detached home is approximately \$39,000. That's more than 15.5 percent of the gross revenues for a

unit that will sell for \$250,000.

The same impact fees for a 3,000-square-foot home in the same jurisdiction is \$42,000 – amounting to just 7 percent of gross revenues for a house that will sell for \$600,000.

If a developer is not aware of this equation he may assume that re-planning the project for more numerous, smaller units will yield larger profits. And he'll be wrong.

Lot count is not always a matter of simple arithmetic, either.

My firm worked on a project that had a 10 percent street slope with houses fronting the road. The street contained 22 lots that required three-foot-high, side yard retaining walls on each lot.

The cost of these retaining walls was projected at approximately \$6,000 per lot for a total cost of \$132,000. If each lot with was widened by six feet to slope more gradually, the need for retaining walls would be eliminated but there would be a loss of two lots.

Still, that wasn't a bad thing. The estimated development profit for each lot was \$30,000,

meaning the reduced lot count would cut profits by \$60,000. But against that, cutting the \$132,000 retaining-wall expense meant that the land's residual value had increased by approximately \$72,000.

Additionally, by providing wider lots, the potential home buyer would perceive that he was gaining more land which might increase the sales price of the unit.

The broader lesson here: Previous planners had reviewed the project in total but failed to review the development costs that specifically pertained to a particular physical location within the project.

A final example of insufficient research prior to planning a project pertains to a local requirement for construction of a high school.

The local jurisdiction required that if the development generated more than 1,000 high school students, the developer would be required to build a high school – a cost of \$50 million. The development in question had approximately 4,250 lots, which generated slightly more than 1,000 high school students.

By reducing the lot count by approximately

300 units, the developer would be required only to pay school mitigation fees totaling \$24 million rather than build a new school.

The revenue loss from trimming the lot count was \$7.5 million. But the \$26 million in savings from avoiding the school-construction requirement meant the reduced lot count actually increased the land's residual value by \$19 million.

Certainly, it is important and healthy for landowners and local governments to jump into new partnerships to retool projects in accordance with significant changes in the current market.

But, as these examples illustrate, they should look – and look very carefully at every assumption they might have – before making the leap.



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