Keys to Increasing Land Residual Value in a Market Downturn

Scot Oldham and Martin Kulli

The authors suggest 12 steps that land developers and owners should pay close attention to before they decide what to do with a property.

The outlook may seem grim for developers, investors, and financial institutions that find themselves stuck with excess land in today's real estate market. As new home sales and construction have come to a virtual standstill, the financial value of both residential and commercial property has plunged across the country. No matter what they want to do with that land, nothing seems to pencil out. What real estate finance experts may not realize is that there are many creative solutions, benefiting both buyers and sellers, available at the price of a little negotiation. In fact, it may be possible to recover much or all of the land's potential value by looking at it in a different light.

For real estate development projects, the key determinant of whether it is worth the time and effort involved is the expected Land Residual Value (''LRV''). Whether it is a prime piece of real estate right in the path of development or an urban infill site that could stir controversy, the basic techniques and considerations for estimating optimal LRV are the same. What would this land be worth if developed to its highest and best use? How much would it cost to develop it that way? The difference is the Land Residual Value. Now the issue is how to increase the Land Residual Value by tweaking the plan or cutting back on costs.

Of course, this isn't quite as easy as it sounds. Profitability is difficult to project because of the uncertain market and the changes that might occur during the multi-year entitlement and construction period. Over the past decade, however, the land development industry has begun to use sophisticated, analytical tools to assist in evaluating all aspects of land development. For example, sophisticated genetic evolvers can accurately predict for maximum land residual values. These new techniques should be implemented wherever possible to ensure project success. A project, planned without using any of these tools or tips, is in need of help.

There are 12 steps that land developers and owners should pay close attention to before they decide what to do with a property. This advice can help both seasoned developers and financial institutions with little experience in real estate to both establish and optimize the value of their property, especially in a declining housing market.

1. Be aware that the land is not worth as much as you would like it to be.

Land is only worth what a buyer will pay. By taking the projected revenues and subtracting the projected costs, landowners can estimate the Land Residual Value of the project. The buyer and the seller effectively split the LRV to arrive at a purchase price. How large or small a piece of the pot goes to the buyer or seller is up for the negotiation. However, if the project is more profitable then the pot is bigger and everyone wins. Unfortunately, now, real estate sales prices are down and market absorption is slow, so the pot is smaller. Therefore, landowners will have to accept lower prices that they would like and perhaps even sell at a loss.

2. Choose the best plan after evaluating several alternatives.

There may be an existing plan for developing property and it might be a good one, but is it the best plan? How many alternatives have been considered? Without

Scot Oldham is senior vice president and Martin Kulli is a project manager with Developers Research, a national real estate consulting firm based in Southern California that provides developers, homebuilders, banks, and private institutional investors with a comprehensive understanding of the value of their development projects.

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options, a landowner cannot make the right decision, the wrong decision, or any decision. To evaluate a property thoroughly requires a highest and best use study of the land. Compare the LRV of several alternatives, i.e. commercial, retail, residential, etc. These alternatives provide a broader understanding of the value of a piece of property.

3. Control costs by identifying the issues early.

Accurate and detailed cost estimates are critical to increasing LRV. If costs can be identified, they can be managed. If not, they will most likely reduce the value of the land. Missing costs, at a project's inception, creates expensive cost overruns and leads to time delays during build-out.

For instance, grading has many associated costs and is often the single largest development cost for a project. In order to understand these costs, a comprehensive grading cost estimate is needed. Without it, many details, such as remedial grading, are overlooked and have the potential to create problems and additional costs. Developers who identify grading issues early can save millions in cost and months of time.

Create accurate, detailed, and workable site plans in the office—not out in the field later. Similarly, land values can be drastically improved by controlling utility capacities, street plans, and storm drain requirements, to name a few. Control costs by identifying them early; not knowing is expensive.

4. Keep your cost estimates accurate and up-to-date.

As a plan changes over time, the cost estimates needs to change. How else can a developer determine the impact of each change? Equally important and difficult is obtaining up-to-date and accurate cost estimates. Prices fluctuate with raw material prices and trade costs. In today's slow construction industry, prices are starting to drop. Projects need a detailed budget estimate, which should be updated monthly, or at the least, quarterly. Manage costs with the help of an up-to-date cost estimate.

5. Optimize your Land Residual Value using both revenue and cost.

The two factors that determine LRV are cost and revenue. To optimize for the maximum land value, consider changes resulting from both factors. A market report will suggest the most appropriate product mix and offer sales projections to help decide a product mix, but this is an incomplete recommendation. Market reports do not address costs. A given product type can create the most revenue, but if the building costs are too high, it will not maximize your LRV. If costs are factored into the product mix decision, the land will reach a more optimal value. That means more profit.

6. Identify requirement thresholds that add significant costs.

Take a detailed look at project constraints to see if they are on the border of triggering any major requirement that will create considerable costs. For example, how many students does it take before a new school is required to be built? In some cases, altering your project plans to a slight reduction in unit count can reduce the total number of students. That will save millions of dollars in school construction costs. The same can be said for the number of car trips, which necessitate the construction of a larger road. In some cases, by using trip reduction techniques, you can save the project substantial offsite road requirements.

Projects have many different expensive requirements. The key to maximizing land residual value is recognizing what factor triggers these requirements, then stopping short of triggering them.

7. Maximize additional revenue through planning.

Premiums are a great source of revenue. For example, if a commercial site is close to a hospital, consider building medical offices, which command large rent premiums. For a residential site with hills, maximize view premiums by single loading streets (building houses on only one side) as much as possible. This might result in fewer units, but it will have less cost, more revenue, and a higher LRV. Parks should be linear to increase frontage and revenue.

People will pay more to live at the end of a cul-de-sac. Also, self-storage generates generous revenues for industrial land. There are numerous premiums for all product types. A market study report should identify and quantify these revenues. By planning for these revenues, landowners or developers can profit from them.

8. Forget using Internal Rate of Returns as a measure of success for land development.

Internal Rate of Return (''IRR'') is great for some types of financial estimating. Land development is just not one of them. The problem with using IRR as a land development metric is the amount of variability inherent in the development process. Time delays are commonplace in land development. Over a short development period, say two years, a delay of two months equates to a more than eight percent longer project time. This affects the project's cash flow. Even minimal changes to a cash flow can significantly detract from an IRR's result.

9. Be as creative and flexible as possible when structuring your land deal.

Instead of closing immediately, create a longer-term escrow allowing for the close of escrow to occur up to 90 days after approval of a subdivision map. This relieves some of the entitlement risk inherent in land development. The seller could then also participate in any price increases based upon a ''to be determined'' formula. Joint ventures also allow the buyer and seller to spread the risk while benefiting both sides. Using creative deal structures can help a borderline deal become a success.

10. Use every possible funding avenue.

There is a wide range of opportunities available to

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developers to fund projects. In predominantly residential projects, create Community Facilities Districts (''CFD'') to fund regional improvements. Use Tax Increment Financing (''TIF'') to share in the profits from future commercial revenues. There are many new government grants encouraging sustainability, energy efficiency, and green building. Use them. Is the land in a redevelopment area? Talk to the city or county planner about incentives for floor area, building height, or parking requirements. Negotiate fee reimbursements from regulatory agencies. In exchange for over-sizing utilities, building parks, or donating open space, many cities or counties will waive fee requirements. A development agreement between the government agency and the developer can address these issues. Seeking different sources of capital will help boost land residual value, especially in a down market.

11. Ensure that your entitlements last through a downturn.

The real estate market is cyclical. There has been a semi-regular pattern of ups and downs for years and most likely this will continue. Make sure entitlements last through the downturn. Negotiate longer terms with a developer's agreement. Create Vested Tentative Tract Maps (''VTTM'') instead of conventional Tentative Tract Maps, allowing a longer time between when a map is approved and when a project is built. This allows landowners and developers to wait out an unforeseen downturn, and build when it is to their advantage.

12. Manage your downside.

Prepare an exit strategy. Keep it updated. Use it. If encountering entitlement problems, be prepared to sell the property to a third party who has a better opportunity to obtain approval because of local connections. The original borrower might sell at a loss, but it is better to lose some of the money than all of it.

Conclusion

These are not just tips for a down market, but good business practices that should be implemented all the time in any economic situation. It seems when times are good fundamentals are overlooked. Things move fast during a booming market. Revenue inflation covers up planning inefficiencies, effectively throwing value away. When the good times return—which they will—developers should continue using the skills and practices that carried them through the market downturn.

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