Fundamental Skills for Real Estate Development Professionals I

Site Selection and Due Diligence

October 17, 2012

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Charles A. Long Properties LLC

10:45 a.m. -12:00 p.m.
Topics we plan to cover

I. Risk management during site acquisition.

II. Maximum supported investment and residual land value

III. Six focus areas of project management and due diligence.

IV. Acquiring the site while conducting due diligence
Learning Objectives:
For you to understand:

1. Risk management for site acquisition.
2. Determining price and terms for site acquisition.
3. Due diligence as part of site acquisition.
Our approach

Overview with class discussion

Ground rule:
Ask questions as they occur to you.
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• Oakland, CA

• Developer specializing mixed use development in California, US
• Consultant on real estate development, redevelopment, capital finance and economic development
• Instructor for ULI Real Estate School on development process, public-private partnerships and sustainable development
• Former city manager of Fairfield, CA and interim manager in Mammoth Lakes, Pinole, and Hercules, California.
• Author of “Finance for Real Estate Development” published April 2011 and contributing author to ULI Retail Handbook.
• Served on 14 ULI advisory panels, chairing panels in Salem OR, Boise, ID and Dallas, TX
• Masters in Public Policy, UC Berkeley; platoon sergeant, US Army
Finance for Real Estate Development
published by ULI
April 2011

Site Selection and Due Diligence
Managing Risk in the Development Process
Development today is more complicated physically and economically

- More urban and mixed use
- Entitlement is longer and riskier
- More complicated economics
- More conversions from old uses
- Less leverage and no “value add” financing
- Density confusion

Appleton Mills, Lowell, MA

Lakeside Steel Plant, Chicago

West End Commons, Oakland, CA
Mixed use challenges

- Community acceptance
- Resizing the infrastructure
- Financing challenges
- Getting the density right
- Sector differences in market strength
- Valuing income and for-sale
- Federal pre-sale requirements for condo projects
- Liability on for-sale residential
- Conflicts among uses
- Parking: costs, layout operations

Bitola, Macedonia

Portsmouth, New Hampshire
The Great Recession has changed the capital stack

- **Much higher equity:** now 35% or more—recourse provisions tighter
- **Disappearance of "Gap" financing to pay for “value-add” conversions**
- **Much lower debt:** now 65% or less
Result of the changes to the capital stack:

- Overall project returns must be higher to attract capital.
- Equity sources have more project control.
Development is…

a separate self financing enterprise that goes from small to large.
The Development Process has three phases:

<table>
<thead>
<tr>
<th>Stages</th>
<th>Pre-Development</th>
<th>Development</th>
<th>Close-out</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of total project budget</td>
<td>5%-15%</td>
<td>80%-90%</td>
<td>5%-8%</td>
</tr>
<tr>
<td>Site selection</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negotiate terms of land acquisition and execute purchase contract</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Due Diligence on land</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Analysis</td>
<td></td>
<td></td>
<td>Leasing or selling</td>
</tr>
<tr>
<td>Pre-leasing and pre-sales planning</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Site Analysis</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Design Development</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project Design</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-construction planning</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financing Analysis</td>
<td></td>
<td>Comply with financing source requirements</td>
<td>Provide return to financing sources</td>
</tr>
<tr>
<td>Financing Commitments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entitlement</td>
<td></td>
<td>Set up property management</td>
<td>Ongoing project management</td>
</tr>
</tbody>
</table>

Site Selection and Due Diligence
“The developer is the conductor of a chaotic and multi-disciplinary process, albeit one that depends on exogenous forces, especially market demand and capital availability.”

“No industry involves the collaborative effort of so many different disciplines to create a product in such a publicly accountable process as development.”
80% to 90% of project value is created in the pre-development phase

Acquisition, design, entitlement, financing, risk management

Project Value
Pre-development work manages risk for all phases

By the start of construction, risks should be reduced to factors that have already been addressed and are controlled through good management.
Pre-development funds are at risk

- Funding for pre-development comes primarily from developer capital.

- If source is outside investors, required return at least 25% and higher.

- Many projects are abandoned when information about costs, markets or government approval conditions show that the project is unviable.
5 Principles of successful development management

1. **Invest in information wisely:** More information reduces risk but it also has a cost. Is the risk of loss worth the reduction in risk?

2. **Manage time:** the longer it takes, the more expensive the process will be.
3. **Manage tasks:** Identify and budget all tasks and monitor.

4. **Anticipate:** Things go wrong in the Development phase because somebody didn’t spend the money early enough, or somebody didn’t communicate key information. Things going wrong early are cheaper than later.
5 Principles of successful pre-development management (continued)

5. Foster teamwork among the professionals: Select an effective team of multi-disciplinary players. Especially, focus on the relationship between the architect and contractor.

a) As much as 80% of project costs will be spent through the contractor, another 5% through the architect. These two disciplines MUST work together.
Six areas of project management

- Site conditions
- Market and Marketing
- Construction cost management
- Financial Viability Analysis
- Entitlement
- Product type and project design
Successful Developers

ANTICIPATE!

It is cheaper to solve problems earlier than later.

Most of the value of a real estate project is created before you start construction.

Site Selection and Due Diligence
Questions

1. Why does a real estate project have the greatest risk of losing money in the early phases?
2. What are the 5 principles of pre-development management?
3. What six areas do you need to focus on to reduce risk and create value in the pre-development phase?
4. What do you need to have accomplished before you spend significant amounts of money on a real estate project?
Project viability
and residual land value
Project return is expressed many different ways

- Pre-tax Internal Rate of Return (IRR)
  - Leveraged
  - Unleveraged
- Net Present Value
  - Present Value of cash flow

- Net operating income/Total cash cost
- Cash-on-cash
- Return on sales (ROS)
- Return on costs (ROC)
- Return on equity (ROE)

Make sure you understand how project return is calculated!
Internal Rate of Return shows the annual return of a cash flow series.

Spreadsheets make it easy:

<table>
<thead>
<tr>
<th>Initial Investment</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>-$100.00</td>
<td>$6.00</td>
<td>$7.00</td>
<td>$8.00</td>
<td>$110.00</td>
</tr>
</tbody>
</table>

7.63% Internal Rate of Return

The discount rate at which the present value of the stream of income equals the amount of the investment.

BUT, FOR IRR TO BE ACCURATE, THE PROJECTIONS MUST BE ACCURATE.
Three elements to evaluate project viability:

1. **Project Value**: based on either total sales or on valuation of the stream of income
2. **The Hurdle Rate**: The minimum rate reflecting the cost of capital and time that the capital is used.
3. **Project Costs**: A valid estimate.
A Project is “viable” if

VALUE minus COSTS
is sufficient to pay:

– Cost of Capital

– Developer profit
– **For Sale Project**: (primarily residential) Gross sales less marketing

– **Income projects** (retail, office, apartments, etc.): INCOME DIVIDED BY A “CAP RATE”.
How to value an “income” project.

- Income project produce annual income from rent, maintenance charges and other sources.
- Apartments, offices, retail stores, business parks are all, usually, income projects.
- The income after expenses is called “Net Operating Income” of NOI. It is the same as annual profit.
- The market values the NOI using something called a “capitalization rate”.
A capitalization rate is simply an shorthand indicator of market strength.

\[
\text{Net Operating Income (NOI)} \quad \text{Cap Rate} = \frac{\text{Project Value}}{\text{NOI}}
\]

\[
\text{Project Value} = \frac{\text{NOI}}{\text{Cap Rate}}
\]

High cap rate indicates market weakness and low cap rate indicates market strength.
Cap rates reflect market sentiment

Source: CBRE, San Francisco

Site Selection and Due Diligence
Cap Rates reflect capital markets and sector differences
Cap Rates in many sectors are recovering (Apartment Cap Rate Trend)

Source: REIS Sept 28, 2012

Site Selection and Due Diligence
Cap rate is the inverse of the P/E ratio used in the stock market

<table>
<thead>
<tr>
<th>Cap rate</th>
<th>P/E Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2%</td>
<td>50</td>
</tr>
<tr>
<td>3%</td>
<td>33</td>
</tr>
<tr>
<td>4%</td>
<td>25</td>
</tr>
<tr>
<td>5%</td>
<td>20</td>
</tr>
<tr>
<td>6%</td>
<td>16.7</td>
</tr>
</tbody>
</table>
Some stock P/E ratios

Average S&P stocks 15.5  
General Electric 14.31  
Microsoft 19.96  
Starbucks 45.22  
Whole Foods Mkt. 32.18

What does a high P/E (or low cap rate) signal about expectations of growth in income?
Pop quiz 1
What is the project value?

<table>
<thead>
<tr>
<th>NOI</th>
<th>Cap Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3,000,000</td>
<td>5%</td>
</tr>
<tr>
<td>$3,000,000</td>
<td>6%</td>
</tr>
<tr>
<td>$2,000,000</td>
<td>4%</td>
</tr>
<tr>
<td>$2,000,000</td>
<td>5%</td>
</tr>
</tbody>
</table>
Investment in real estate compared to investment in stocks

• A real estate project’s “stabilized” NOI is frequently perceived as more predictable than future earnings of a company.

• Cap rates in 1990’s were 8% and up.

• In 2000’s they dropped in some markets for some sectors below 5%.
Web sites where you can obtain current market data

- **Real Estate Research Council**
  [www.rerc.com](http://www.rerc.com)

- **Real Capital Analytics**

- **National Council of Real Estate Investment Fiduciaries (NCREIF)**
  [http://www.ncreif.com](http://www.ncreif.com)

- **Reis**
Questions

1. What is happening with cap rates today?

2. Are they different for different regions? For different sectors? Why?
DETERMINING THE ROC HURDLE
Cost of capital: blended cost of equity and debt over the time to construct.

Example
Cost of equity: 20% per year (30% of costs) = 6%

Cost of debt: 5% per year (70% of costs) = 3.5%

TOTAL ANNUAL COST OF CAPITAL = 9.5%

If a project takes 2 years to construct, cost of capital is: 9.5% per year or a total of about 20%.
Typical hurdle rates based on duration of development period

1-year: about 10%
2-years: about 20%
3-years: about 30%
### Hurdle rates for other capital structures and construction periods

<table>
<thead>
<tr>
<th>Months to achieve project value</th>
<th>Debt</th>
<th></th>
<th>Equity</th>
<th></th>
<th>Hurdle Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% funding</td>
<td>Interest</td>
<td>% funding</td>
<td>Annual return</td>
<td></td>
</tr>
<tr>
<td>36</td>
<td>75%</td>
<td>6.00%</td>
<td>25%</td>
<td>20%</td>
<td>31%</td>
</tr>
<tr>
<td>36</td>
<td>80%</td>
<td>6.00%</td>
<td>20%</td>
<td>20%</td>
<td>29%</td>
</tr>
<tr>
<td>24</td>
<td>75%</td>
<td>6.00%</td>
<td>25%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>24</td>
<td>80%</td>
<td>6.00%</td>
<td>20%</td>
<td>20%</td>
<td>18%</td>
</tr>
<tr>
<td>12</td>
<td>80%</td>
<td>6.00%</td>
<td>20%</td>
<td>20%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Site Selection and Due Diligence
The “hurdle rate” is the minimum return necessary for a project to be viable

- Cash-on-cash hurdle rate: *a shortcut to evaluate project viability*

- Detailed cash flow on each land acquisition opportunity is impractical and inaccurate

- Use a the same cash-on-cash hurdle rate where you have projects that share the same financing and “product absorption” characteristics.

- Once a property is tied up, and more information is available, do a more detailed IRR analysis.
OK. Once you have Project Value and Hurdle Rate, then you can determine how much you can afford to spend on a project compared to what it is estimated to cost.

$$\text{Maximum supported investment} = \frac{\text{Project Value}}{1 + \text{hurdle rate}}$$

If estimated project costs exceed the Maximum Supported Investment then the project is not viable and the developer will abandon the project.
A cash-on-cash return evaluates project viability based on estimates of cost and value

- Be careful to include adequate cost allowances for all categories and, especially, contingency.

- Use a cash-on-cash hurdle rate for projects with similar capital stacks and absorption profiles.
Pop quiz 2

What is the maximum supported investment?

<table>
<thead>
<tr>
<th>Project Value</th>
<th>Hurdle Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$36,000,000</td>
<td>20%</td>
</tr>
<tr>
<td>$39,000,000</td>
<td>30%</td>
</tr>
<tr>
<td>$50,000,000</td>
<td>25%</td>
</tr>
<tr>
<td>$60,000,000</td>
<td>25%</td>
</tr>
</tbody>
</table>
Land price is usually the first cost that the developer determines.

If the land price cannot be supported by the project, the developer should immediately abandon the project.
Residual Land Value is:
The price the project can afford for land after all other costs of development.

Obtaining site control by tying up the land is the first major decision a developer makes and is based on market and costs.

If the costs of development change, the developer risks a loss because the land price has already been determined.
Residual land value is the land component of supported investment.

\[
\frac{\text{Project Value}}{1 + \text{hurdle rate}} - \text{Costs without land} = \text{Residual land value}
\]

Site Selection and Due Diligence
## Pop quiz 3
What is the project residual land value?

<table>
<thead>
<tr>
<th>Project Value</th>
<th>Project Cost (w/o land)</th>
<th>Hurdle Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$36,000,000</td>
<td>$25,000,000</td>
<td>20%</td>
</tr>
<tr>
<td>$39,000,000</td>
<td>$25,000,000</td>
<td>30%</td>
</tr>
<tr>
<td>$50,000,000</td>
<td>$35,000,000</td>
<td>25%</td>
</tr>
<tr>
<td>$60,000,000</td>
<td>$43,000,000</td>
<td>25%</td>
</tr>
</tbody>
</table>
Residual land value is what is left to afford

Sale price of house #1: $500,000

Sale price of house #2: $500,000

Residual Land Value

Agency requirements

Profit

Design, finance, management, marketing

Construction

Site Selection and Due Diligence
Land Value Changes with Use

**Example on 3 acres**

**Scenario 1**

- 80 townhomes

- **net sales:** $24 million

- **costs (before land):** $16,000,000.

- **land value (20% hurdle):** $4.0 million
Land Value Changes with Use
Example on 3 acres

Scenario 2:
210 apartments (podium)
NOI: ($30/sf rent): $3.3 million.
Project value: $65.5 million (5% cap)
costs (before land): $42 million.
land value at (30% hurdle) $8.4 million.
The return on a project pays:

- **Cost of debt**: interest on a construction loan (4%-6%)
- **Return on equity**: return to investors (15% to 20%)
- **Developer profit**: based on project performance after paying costs of capital.
Developer profit comes from:

- **Fees:** Developer fee of 2-4% of cost with incentive bonuses.
- **Co-investment:** Developer is an equity investor in 10-15% of equity requirement.
- **Sharing of success:**
  - Participation in profits over the “preferred return” of 8-12%
  - Higher participation in profits over a target of 15-18%.
What happens to a project’s financial viability if:

- The entitlement is long and costly?
- The public agency suddenly changes the development conditions?
- The public agency’s development conditions are uncertain?
- The cost of development conditions causes total costs to exceed project value?
How should you adjust residual land value for:

- Long and costly pre-development?
- Longer construction period?
- Higher market risk?
- High land deposit payments during pre-development?
- Higher city development fees?
- Land as “equity”?
Questions

1. Why is it important to determine land prices as early as possible?
2. What information do you need to determine whether land price is affordable by the project?
3. What challenges do you face in acquiring land?
The six focus areas of project management and due diligence
Project Management

• Development is a “team process”—create and foster a common vision.

• Have a complete list of all tasks—Monitor!

• Foster the architect/contractor relationship: Insure it is collaborative not confrontational.

• Understand what components cost compared to their value.
Shape the land acquisition terms to the information

- Site analysis
- Market assessment
- Community Support
- Project design
- Construction costs

Financial analysis to acquire land at no more than its Residual Land Value
Perceived risk in each area will affect project return requirements

Site Conditions
- Environmental hazards
- Surrounding uses

Market
- Sector
- Volatility
- Location
- Region

Project Design
- Constructability
- Response to market

Construction
- Inflationary conditions
- Contractor Experience
Site analysis effects development potential and costs

- Area and boundaries
- Ownership
- Condition of title
- Surrounding uses
- Hazardous waste, poor soils or other special conditions?

- Evaluate—
  - Cost increases
  - Ability to proceed
- Before or after due diligence.
- Insure conditions to close in PSA backstops
The market determines what your project is worth

- Total sales or
- NOI valued at a cap rate
- Capital market conditions
- Verify with outside experts

- The market now, NOT wishful thinking.
- Shape the unit mix, layout and amenities
- Anticipate the marketing strategy.
Know the community (the entitlement process)

- Approving authority
- Regulatory structure
- Stakeholder involvement
- Cost of conditions
- Cost and time for processing

- Try to obtain commitments from the public agency.
- Meet early with stakeholders.
- Create ownership.
Project design responds to market, entitlement and cost.

- Density, units, parking, access, circulation
- Market analysis informs product design
- Pay attention to density/cost tradeoffs

- More is not always more.
- Understand cost and value.
Construction costs

- Estimate each cost category, do not lump!
- Know the market for construction services.
- Identify areas of uncertainty
- Include a contingency
- Involve the contractor in design.
- Solve cost problems early
- Foster relationship between architect and contractor.
Financial Analysis

- No wishful thinking—VALIDATE!
- Work to reduce uncertainty.
- Include a contingency—higher at the beginning.
- Update continuously!

- Use a valid hurdle
- Understand the economics of each component
- You can’t cut the board longer.
Cost pro-forma includes:

1. Building costs
2. Site Development (demolition, grading, utilities and landscaping)
3. Parking (may be included in building for some types of projects)
4. Connection and impact fees
5. Offsite costs such as traffic signals or road improvements
6. Design (architecture, engineering, consultants, etc)
7. Marketing (brokers, advertising, etc.)
8. Construction management
9. Financing /legal/administrative
10. Taxes during construction
11. Contingency: 10-15% in early stages

Site Selection and Due Diligence
DO NOT LUMP COSTS!

UNDERSTAND COSTS AND VALUE!

YOU CANNOT CUT THE BOARD LONGER!
The economics of density: More is sometimes less
Why things go wrong

• Somebody didn’t spend the money early enough.
• Somebody didn’t communicate key information.
• Things going wrong early are cheaper than later.
• Control risk through due diligence and communication.

The best way to solve a problem is to find out about it early enough to do something about it.
Questions

1. Why is development a team process?
Acquiring the site

Figure 3.7: Area Two zoning designations as of 2007. Source: City of Newark GIS information.
The first six steps

1. Look for sites, investigate and identify those with promise.
2. Do the six part analysis on the promising sites and decide what the site is worth.
The first six steps (continued)

4. Make the offer: Letter of intent (LOI) or letter offering to purchase. This step frequently goes on for a while.

5. Execute a purchase contract setting forth detailed terms of purchase and period of due diligence.
The first six steps (continued)

6. Conduct the due diligence process prior to escrow deposits becoming non-refundable so you can get them back if you decide not to proceed.
Looking for sites

• Immerse yourself in the community, drive it, bike it, walk it, understand it.
• Meet with community groups
• Map it: Google maps, parcel map services
• Immerse yourself in the market: Internet data, visit projects, talk to tenants.
Looking for sites (continued)

- Talk to city hall
- Attend city council meetings
- Understand the entitlement process.
- Develop relationships with brokers, but recognize that brokers have only a part of the market.
Decide what the site is worth

• Organize your analysis around the six focus areas.
• Identify the areas of uncertainty and do more research.
• Exercise judgment about market, construction and entitlement risk.
Begin negotiations

• Find out about the owner.
• Obtain as much information as possible from the owner during negotiations.
• Understand before proposing.
• Use the open book, where possible
• Be trustworthy: never, never promise something you can’t do.
• Recognize that buying land is a relationship.
Making the offer

• A clear succinct letter of intent (LOI) or offer sets forth the major business terms.
• Ask for concurrence on the letter as prerequisite to the attorneys negotiating the purchase contract.
• Provide a reasonable time to execute the contract.
The purchase contract

- The property is “tied up”.
- Now you can spend money on investigation (due diligence).
- Insure that there is adequate due diligence time. Try to get as long as possible.
- Refundable deposit during due diligence.
- Minimize amount of non-refundable deposits prior to close of escrow.
The purchase contract (continued)

- Focus on buyer’s conditions to close:
  - Condition of title and buyer’s obligations to deliver clear title.
  - Environmental and soils
  - Conditioned on receiving entitlement?
  - Maximum period to meet conditions
  - Deposit refund conditions
Due Diligence

- Engage your development team on the six areas of focus and pay them to get more reliable information.
- Decide impact of more reliable info on contract price.
- Decide whether to
  - proceed,
  - renegotiate, or
  - abandon.
Typical due diligence cost:
first 60-120 days
(<= $100 million project)

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Soils, survey, title and environmental</td>
<td>$20,000</td>
</tr>
<tr>
<td>Market Analysis</td>
<td>$7,500</td>
</tr>
<tr>
<td>Preliminary project design</td>
<td>$10,000</td>
</tr>
<tr>
<td>Determine entitlement process and likely conditions</td>
<td>$7,500</td>
</tr>
<tr>
<td>Pre-construction services</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total budget during refundable period</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
Common issues encountered in due diligence

- Title to property not clear.
- Easements prevent full site utilization.
- Survey finds less land.
- Soils not good for construction.
- Environmental hazards.
- Zoning or development requirements different
- Development fees higher
Common issues encountered in due diligence (continued)

- Construction costs higher
- Market strength weaker
- More controversy in community
- Site layout or unit production different
A real estate project’s 3 funding baskets

**Basket 1**
Prior to site control
- Preliminary research,
- purchase contract,
- refundable deposits,
- initial due diligence

**Basket 2**
After site control
- Entitlement,
- non-refundable (hard) deposits and design.
  *Time is not your friend*

**Basket 3**
Begin construction
- Construction and delivery

**EASY**
Limit expenditures from Basket 2 with careful initial due diligence, good purchase terms and careful entitlement management.

**HARD**

Site Selection and Due Diligence
Acquisition Do’s

DO

• Base value on market, entitlement, and current costs and prices, not on comps and guesses.

• Create a relevant list of “buyer’s conditions to close”

• Be prepared to abandon the site if due diligence discloses information that is inconsistent with the assumptions that determined price.

• Understand how much “Basket 2” money you will need.
Acquisition Don’ts

DON’T

• Skimp on the cost of researching due diligence issues.
• Proceed beyond due diligence if there are major issues unresolved.
• Engage in wishful thinking about resolving due diligence concerns.
• Close without entitlement unless prepared to live with the consequences of no entitlement.
• Deposit non-refundable money unnecessarily.
• Make un-necessary commitments to Seller or to entitlement entity.
Questions

Why is effective due diligence so important to the success of a real estate project?