Fundamental Skills for Real Estate Development Professionals I

Site Selection and Due Diligence

November 6, 2013

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10:45 a.m. -12:00 p.m.

Topics we plan to cover

I. Pre-development risk

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. Managing risk.
2. Return requirements.
3. Determining price and terms for site acquisition.
4. 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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- 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. Winner of Silver Award NAREE, June 2012
- Served on 16 ULI advisory panels, chairing panels in Salem OR, Boise, ID, Dallas, TX, Buffalo, NY and Pasco County FL.
- Masters in Public Policy, UC Berkeley; platoon sergeant, US Army

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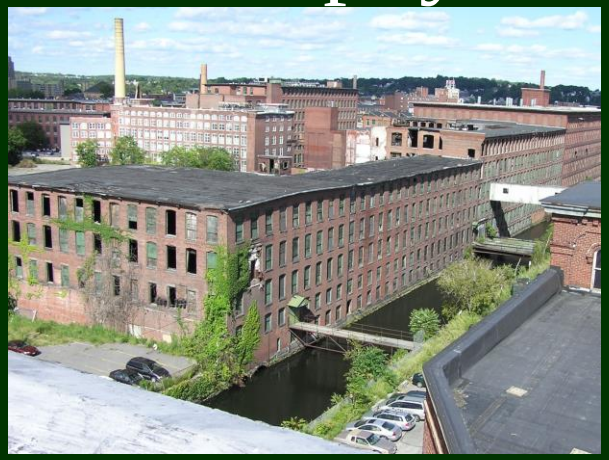
Managing Risk in the Pre-development Process

Development today is more complicated physically and economically



Appleton Mills, Lowell, MA

- 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

Lakeside Steel Plant, Chicago

West End Commons, Oakland, CA

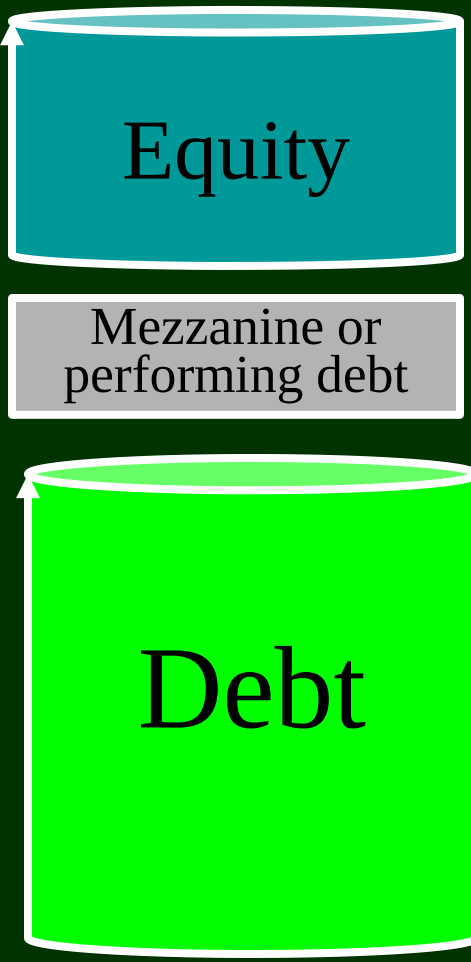
Mixed use challenges

Bitola, Macedonia

Portsmouth, New Hampshire

- 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

The Great Recession has changed the capital stack



Much higher equity: now 35% or more—recourse provisions tighter

Scarcity of "Gap" financing to pay for “value-add” conversions

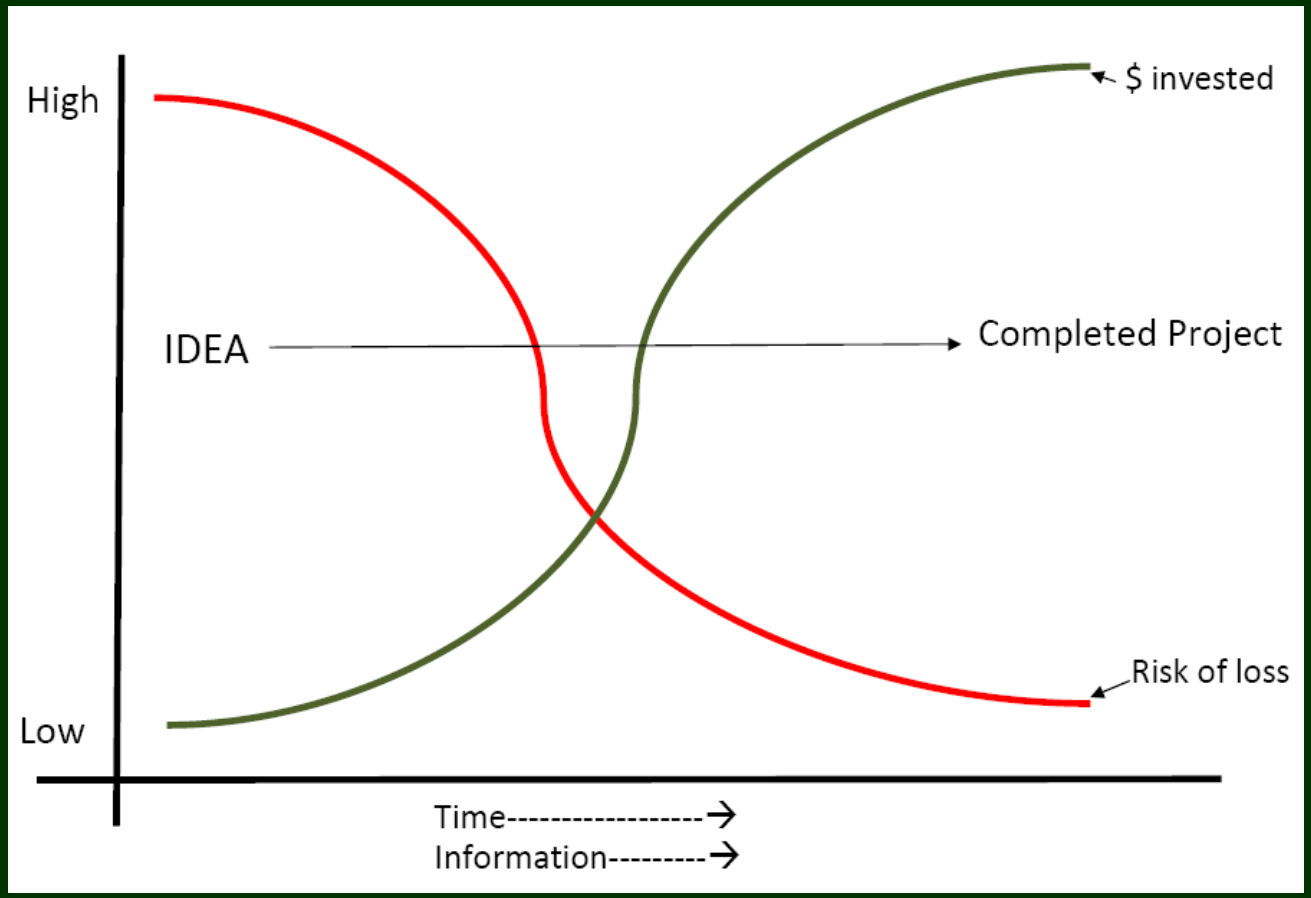
Much lower debt: now 65% or less

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.



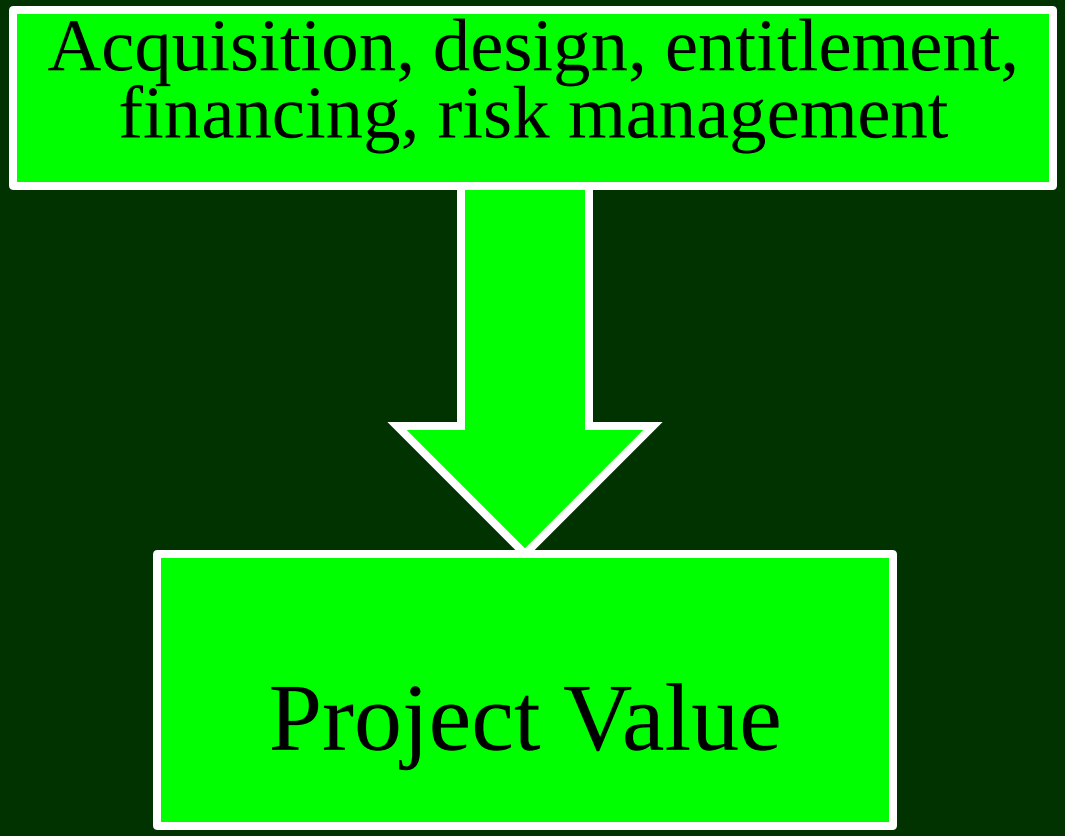
The Development Process has three phases

Stages	Pre-Development	Development	Close-out
% of total project budget	5%-15%	80%-90%	5%-8%
TASKS	*Site selection*	*Close on land purchase*	
	Negotiate terms of land aquistion and execute purchase constract		
	Due Diligence on land		
	Market Analysis	*Continue to monitor market conditions and financial viability*	*Leasing or selling*
	Pre-leasing and pre-sales planning	*Initiate marketing and lease-up/sale*	
	Site Analysis	***Construction:*** *Implement construction management strategies*	*Construction close-out, punch list and tenant move in*
	Design Development		
	Project Design		
	Pre-construction planning		
	Financing Analysis	*Comply with financing source requirements*	*Provide return to financing sources*
	Financing Commitments		
	Entitlement	*Set up property management*	***Ongoing project management***

"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



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

- Primarily from developer capital.
- If from outside investors, return likely 25% or higher.
- Projects are abandoned when information about costs, markets or government approval conditions show that the project is unviable.

Norms for success

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

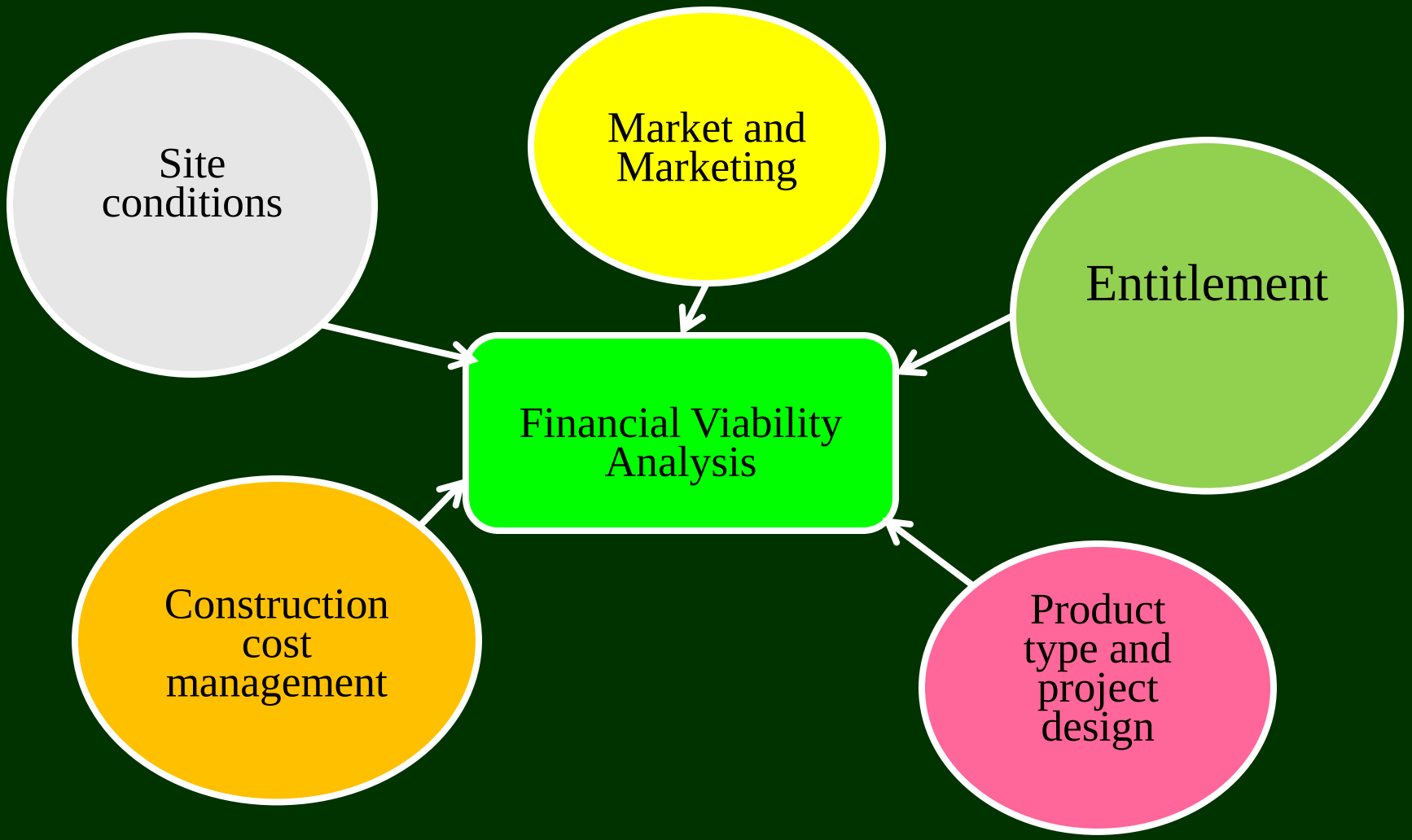
2. Time and tasks: the longer it takes, the more expensive the process will be. Manage and budget tasks.

Norms for success

3. Anticipate: Things going wrong early are cheaper than later.

4. Foster teamwork: Real estate development is inherently interdisciplinary. 80% of costs spent through two team members: contractor and architect. These two disciplines MUST work together.

Six areas of focus



Risks in each area affect project return and viability

Site Conditions
- Contamination and soils
- Surrounding uses
- Boundaries, area and access
- Ownership and easements

Design
- Product type
- Height, density, layout
- Parking
- Elevations

Entitlement
- Time
- Cost
- Stakeholders
- Conditions of approval
- Vesting
- Fees
- Entitlement at building permit

Market
- Sales and rental rates
- Customer profiles
- Unit mix and amenities
- Project Value

Construction
- Cost estimates
- Constructability
- Management

Investigate, Validate and Relate!

Site Conditions
- Title reports, surveys, maps
- Specialized consultants and reports
- Inform design

Design
- Engage architect early!
- Foster teamwork
- Specialized services (traffic, engineering, etc)

Entitlement
- Map the process
- Identify tasks and budgets
- Talk to stakeholders
- Work with the professional staff
- Visit council meetings
- Identify uncertainties and strategies to resolve early

Market
- Market consultants
- Inform design
- Inform marketing

Construction
- Engage contractor early!
- Foster teamwork
- Use adequate contingencies

Financial Analysis

- Use current market and costs—avoid wishful thinking
- Identify sensitive numbers—focus on reducing uncertainty by paying for and getting more information
- Incorporate time and cost of capital—use a valid hurdle rate
- Use an adequate contingency

Successful Developers ANTICIPATE!

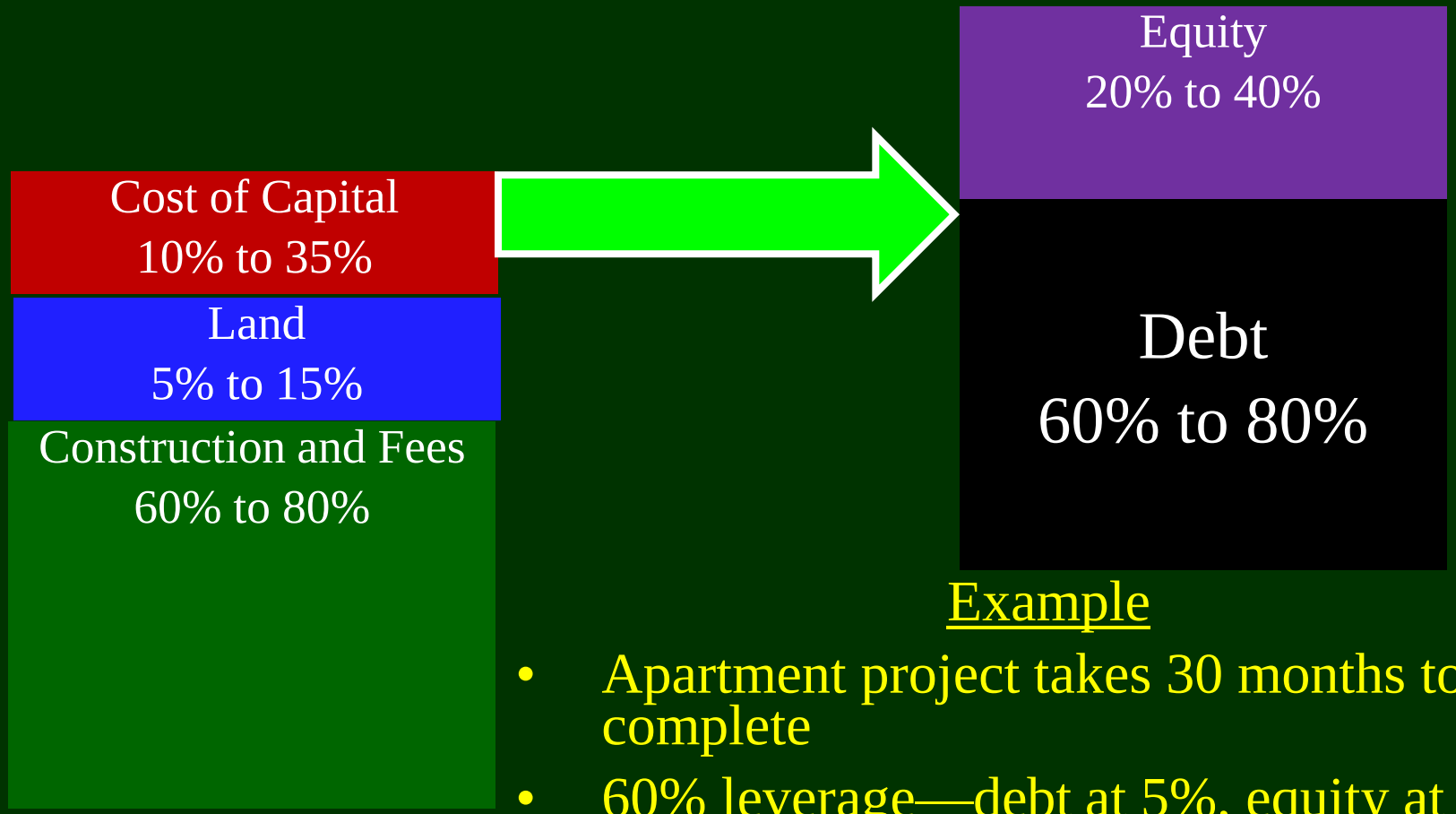
Most of the value of a real estate project is created before you start construction.

Questions

1. Why does a real estate project have the greatest risk of losing money in the early phases?
2. Why is it so important to foster teamwork?
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

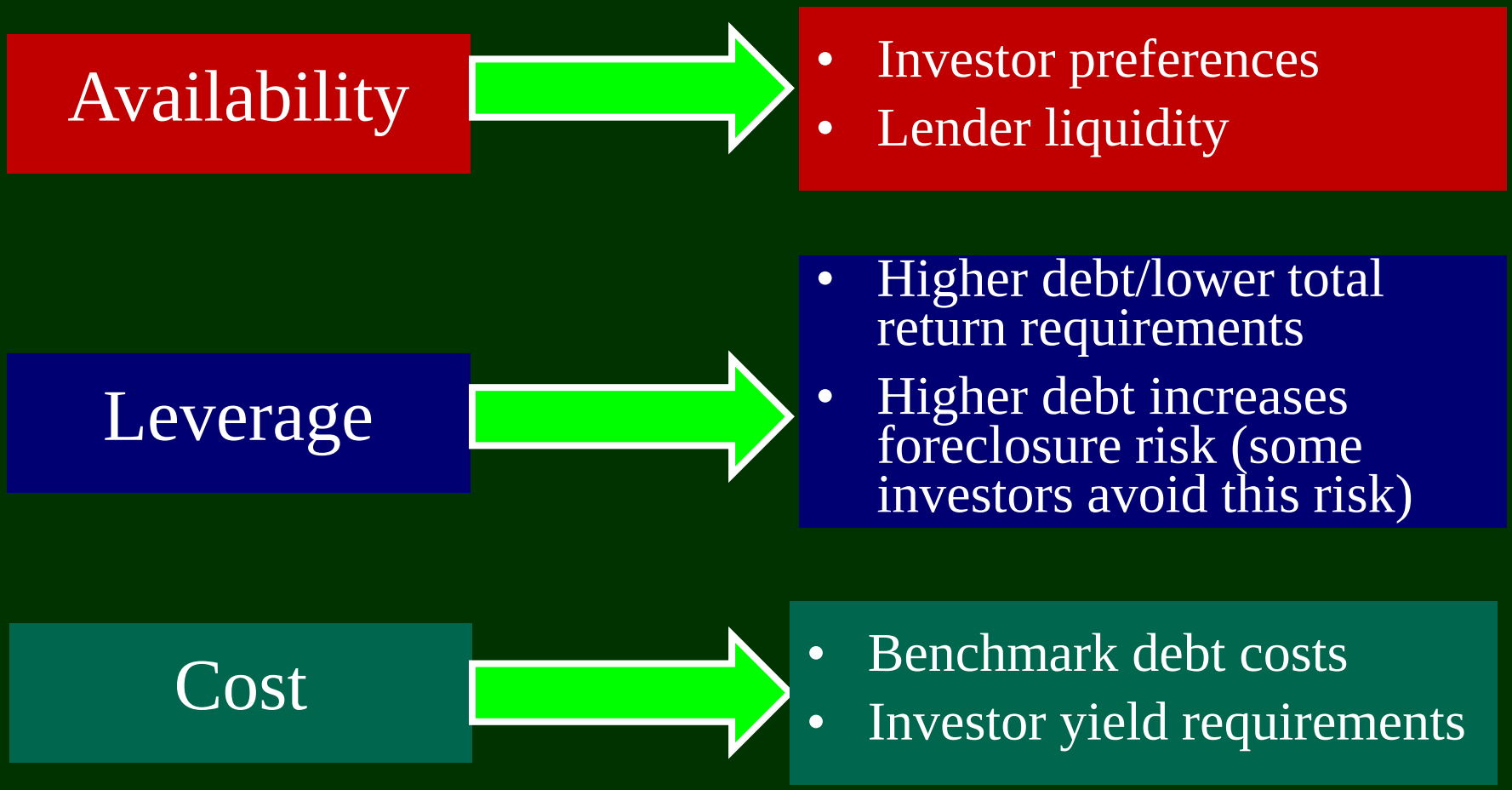
Real Estate is Capital Intensive



Example

- Apartment project takes 30 months to complete
- 60% leverage—debt at 5%, equity at 20%
- Cost of capital = 30% of other projects costs

Dimensions affecting capital



A Project is "viable" if

VALUE minus COSTS
Creates sufficient return to pay:

- Cost of Capital
- Developer profit

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:

	Income for each period			
Initial Investment	**1**	**2**	**3**	**4**
-$100.00	$6.00	$7.00	$8.00	$110.00
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.

But, early in a project focus on three parameters

1. Project Value: based on either total sales or on valuation of the stream of income
2. Project Costs: A valid estimate.
3. The Hurdle Rate: The minimum return on costs necessary to pay the cost of capital (and developer profit) for the time that the capital is used.

Start with the project's market value

- For Sale Project: (primarily residential) Net sales: Gross sales less marketing
- Income projects (retail, office, apartments, etc.): NET INCOME DIVIDED BY A "CAP RATE".

Learn to see the layout. Match the product type to the location. Two examples at 3 acres

80 townhomes

Project value
$24 million

210 apartments
NOI: $3.3 million.
Project value:
$65.5million (5% cap)

Valuing a stream of income

- The income after expenses is called "Net Operating Income" or NOI. It is the same as annual profit.
- Investors value the NOI using a "capitalization rate" which is an all-in metric reflecting capital availability, leverage, cost and perceived regional and sector differences. .

Cap rate: an all-in indicator of market strength.

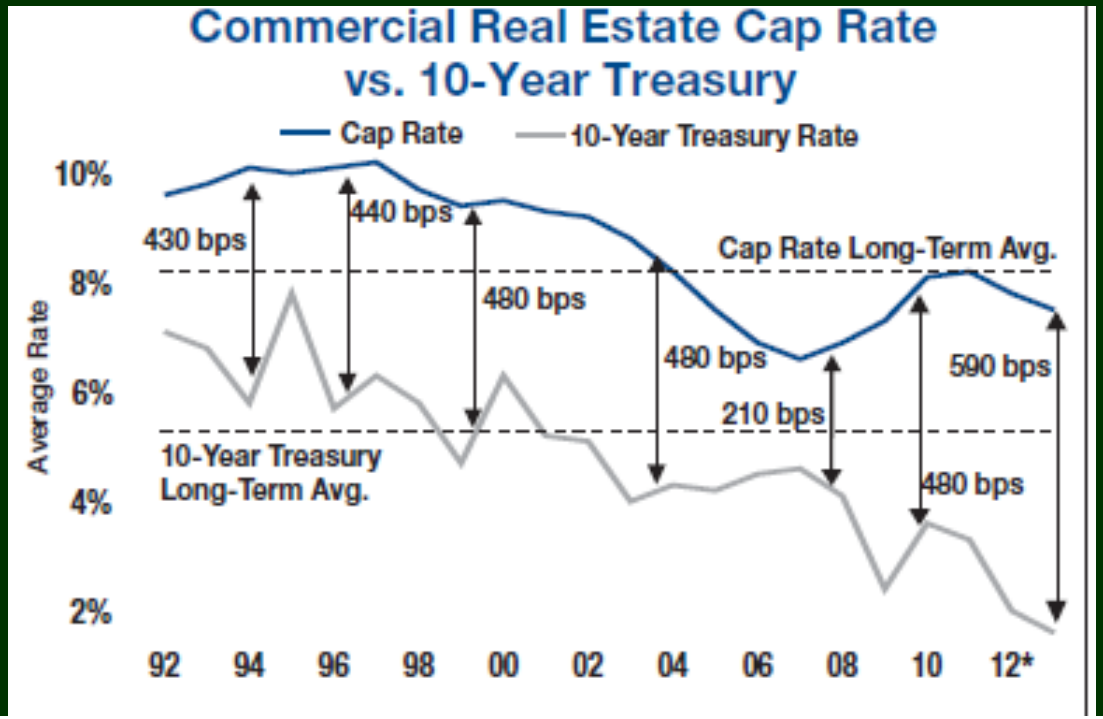
$$\text{Cap Rate} = \frac{\text{Net Operating Income (NOI)}}{\text{Project Value}}$$

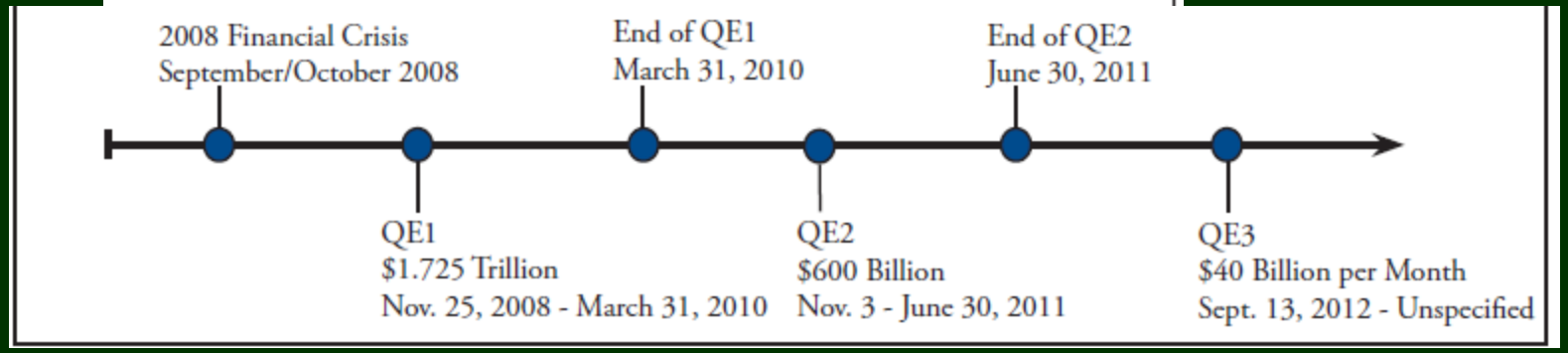
$$\text{Project Value} = \frac{\text{NOI}}{\text{Cap Rate}}$$

High cap rate indicates market weakness.

Low cap rate indicates market strength.

Cap rates have come down with interest rates, but spread over 10-year treasury is at an all time high.





What happens to cap rates when the Fed stops increasing the money supply?

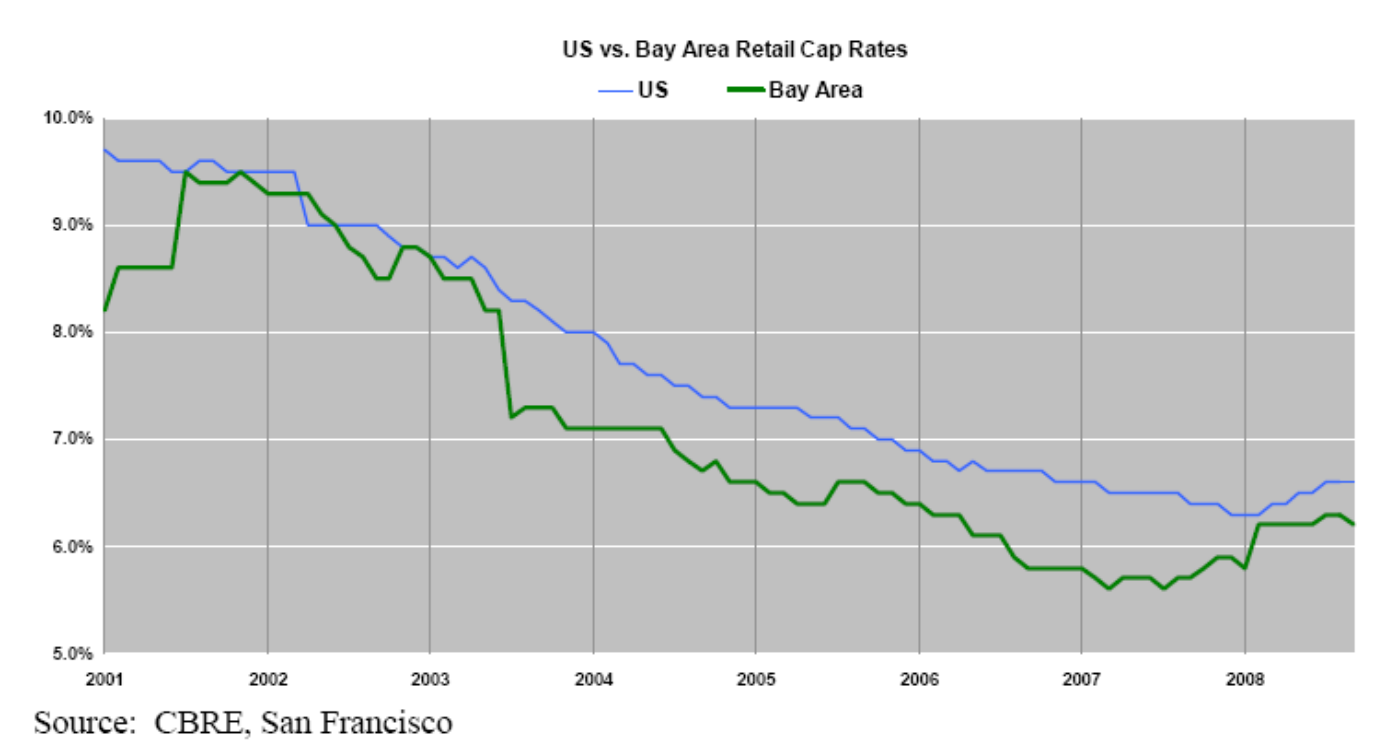
Cap Rates reflect sector differences

Cap rates by property type

Property type	Cap. Rate August 2012 (percent)	Expected cap. Rate December 2013 (percent)
Apartment: high income	5.67	5.85
Central city office	6.15	6.17
Apartment: moderate income	6.11	6.27
Regional malls	6.37	6.51
Warehouse industrial	6.92	6.87
Neighborhood/community shopping centers	6.97	7.05
Full-service hotels	7.27	7.38
Power centers	7.42	7.63
R&D industrial	7.62	7.64
Suburban office	7.9	7.94
Limited-service hotels	8.16	8.24

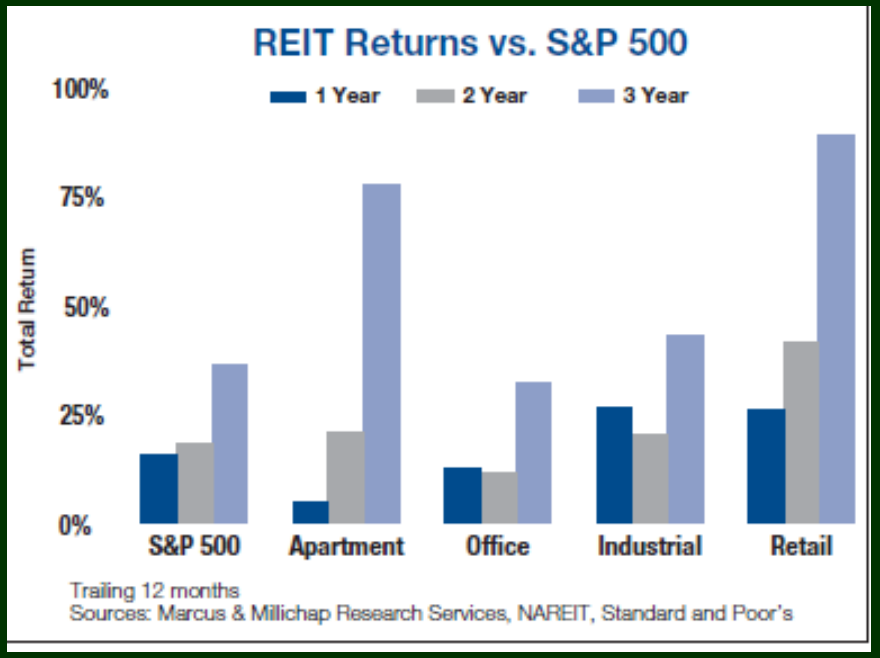
Source: Emerging Trends 2013

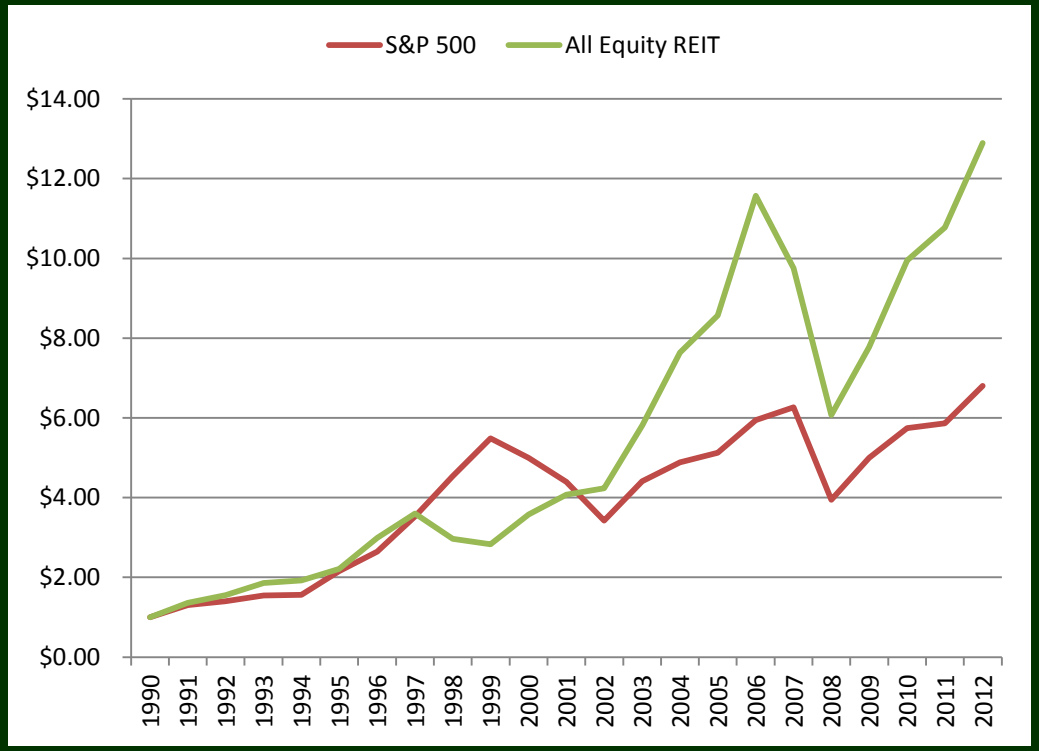
Cap rates reflect regional differences



Source: CBRE, San Francisco

Real estate has recently beaten other investments





Cap rate is the inverse of the P/E ratio used in the stock market

Cap rate	P/E Ratio
2%	50
3%	33
4%	25
5%	20
6%	16.7

Some stock P/E ratios

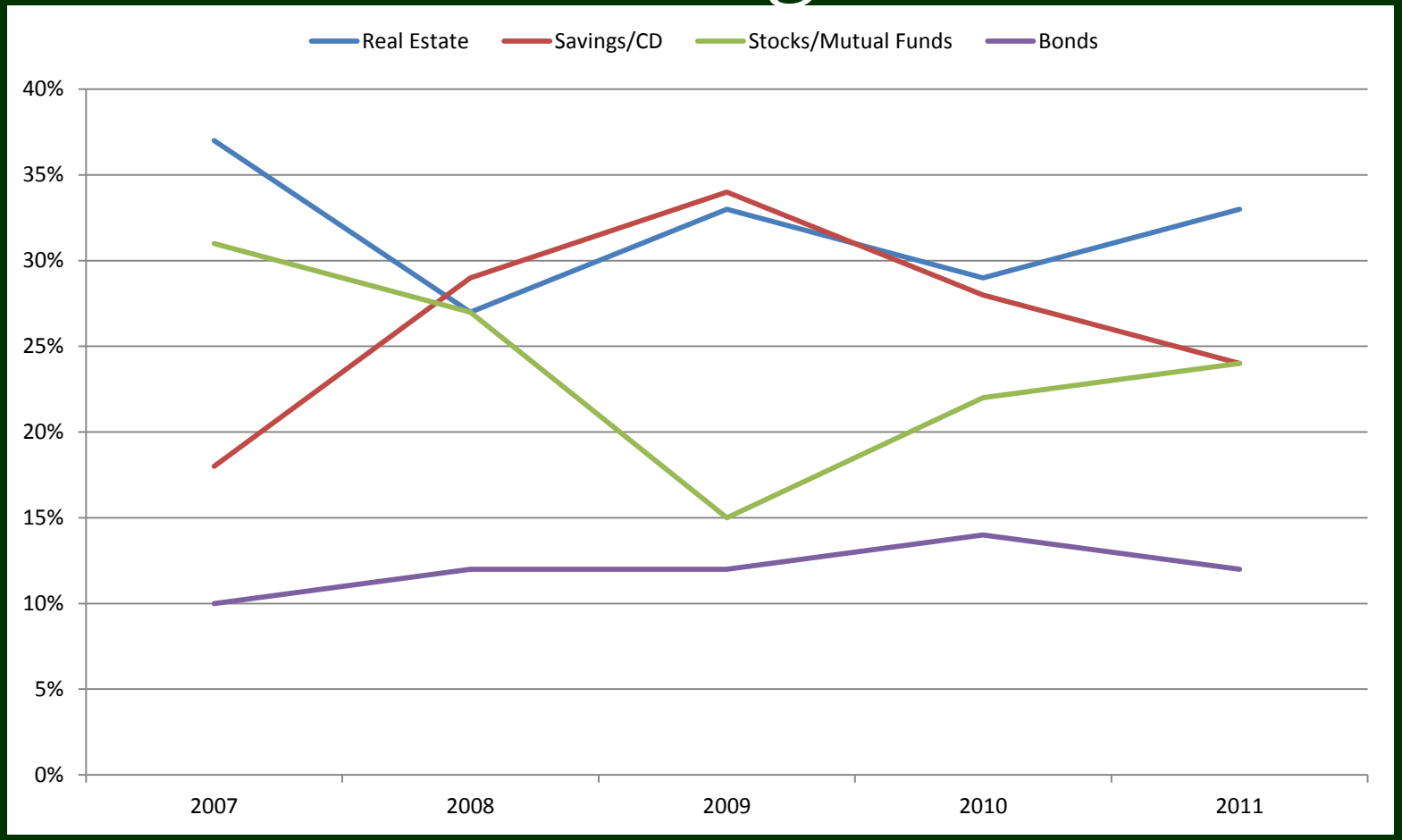
Average S&P stocks	15.5
General Electric	14.31
Microsoft	19.96
Starbucks	45.22
Whole Foods Mkt.	32.18

What does a high P/E (or low cap rate) signal about expectations of growth in income?

Real estate investment has evolved over the last 20 years.

- Cap rates in 1990's were 8% and up. Then came CMBS and capital liquidity.
- Early 2000's cap rates dropped in some markets for some sectors below 5%.
- We are now experiencing in some regions the same exuberance.

Preferences of US Investors for asset categories



Pop quiz 1
What is the project value?

NOI	Cap Rate
$3,000,000	5%
$3,000,000	6%
$2,000,000	4%
$2,000,000	5%

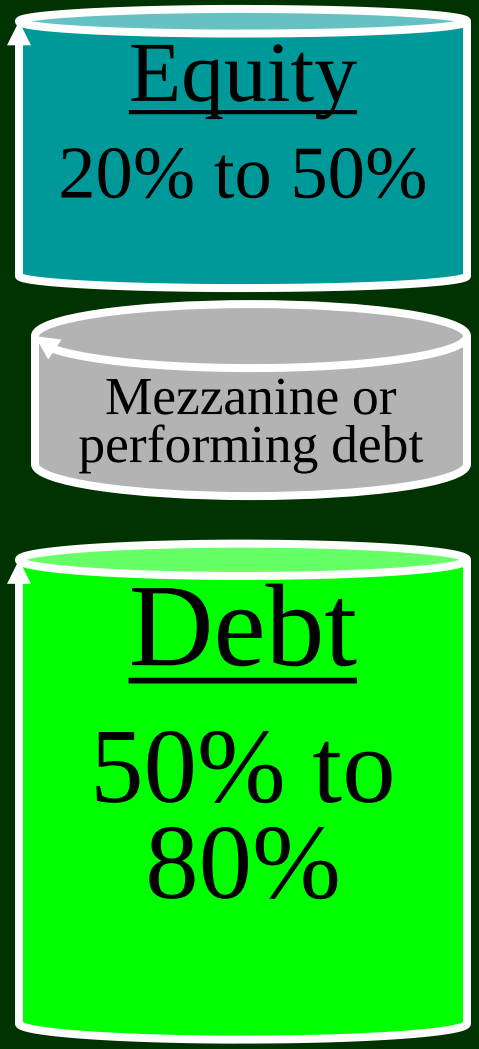
Web sites where you can obtain current market data

- Real Estate Research Council www.rerc.com
- Real Capital Analytics http://global.rcanalytics.com/
- National Council of Real Estate Investment Fiduciaries (NCREIF) http://www.ncreif.com
- Reis: http://www.reis.com/index.cfm

Questions

1. What is happening with cap rates today?
2. Are they different for different regions? For different sectors? Why?
3. How do these market conditions affect your site acquisition strategies?

Capital underwriting parameters



- Preferred 8%-12%
- Target 15%-20%
- Upside potential

Projected 20% or greater for value add investment.

15-30 year amortization

4-10 year term

3% to 6.5 % interest

DETERMINING THE ROC HURDLE

A blended cost of equity and debt over the time to construct and deliver.

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

Months to achieve project value	Debt		Equity		Hurdle Rate
	% funding	Interest	% funding	Annual return	
36	75%	6.00%	25%	20%	31%
36	80%	6.00%	20%	20%	29%
24	75%	6.00%	25%	20%	20%
24	80%	6.00%	20%	20%	18%
12	80%	6.00%	20%	20%	9%

Cash-on-cash hurdle rate: *an initial evaluation of 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 cash flow analysis showing detailed distribution to underwriting sources.

With Project Value and Hurdle Rate, then 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.

Pop quiz 2
What is the maximum supported investment?

Project Value	Hurdle Rate
$36,000,000	20%
$39,000,000	30%
$50,000,000	25%
$60,000,000	25%

Land price is usually the first cost that the developer determines.

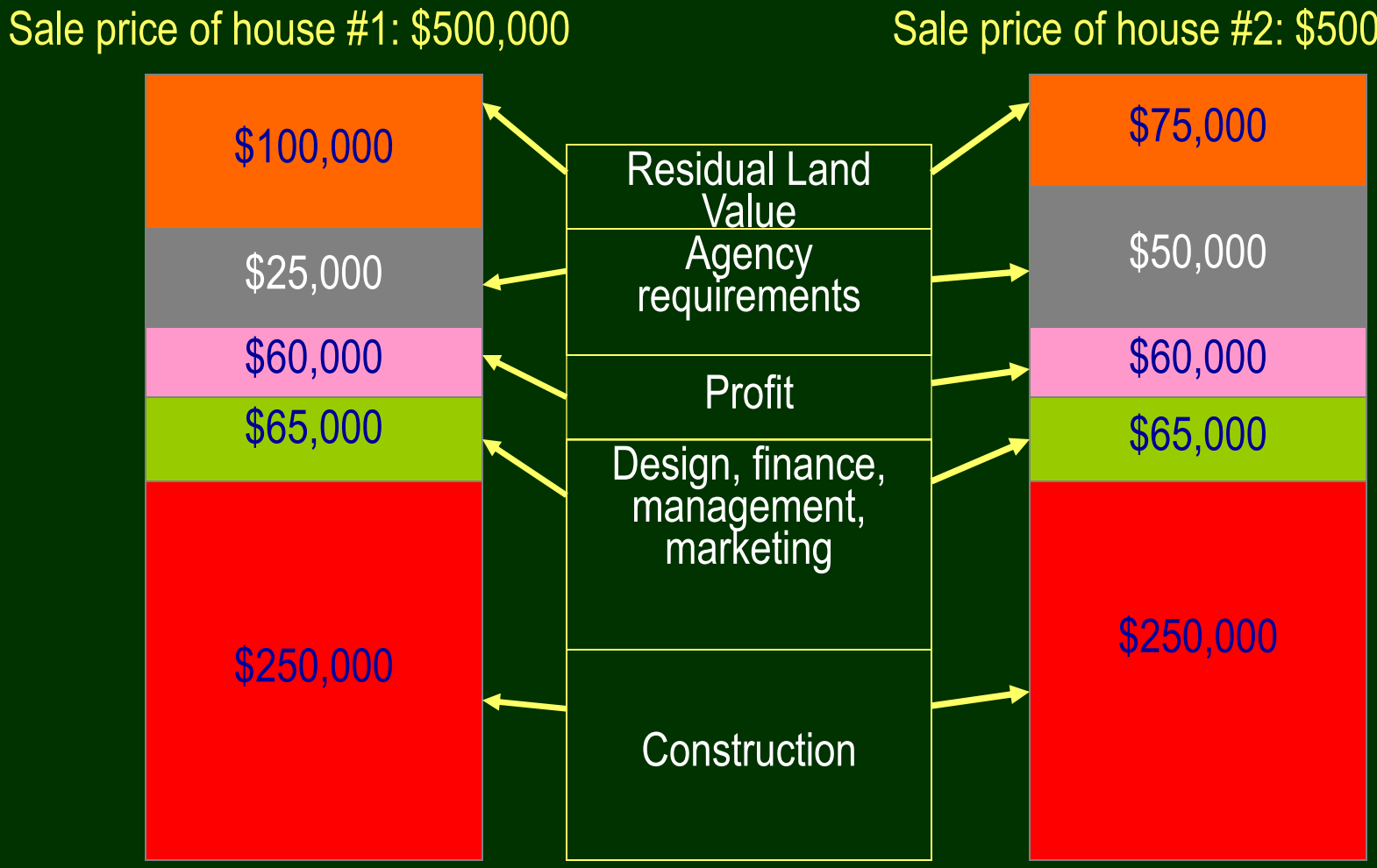
But, if the land price turns out to be too high, it will be almost impossible for the project to financially recover.

Important to constantly monitor market and costs to insure that project viability continues.

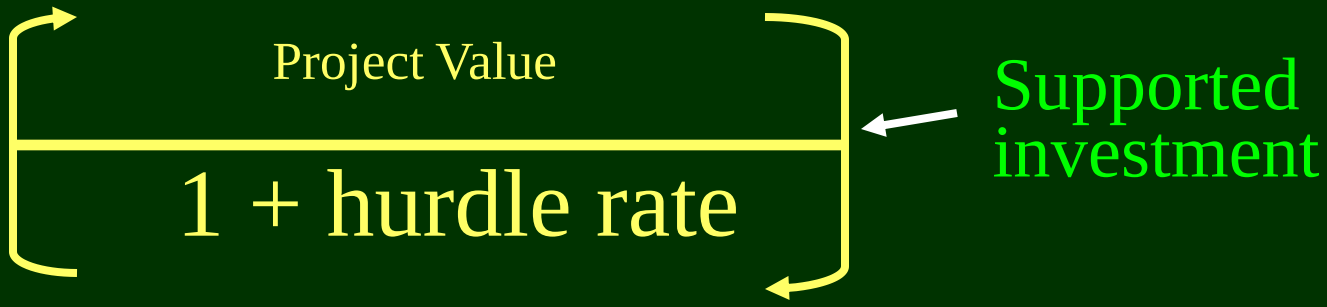
Residual Land Value is:

The price the project can afford for land after all other costs of development.

Or, residual land value is what is left to afford



Residual land value is the land component of supported investment.



MINUS

Costs without land

=Residual land value

Pop quiz 3

What is the project residual land value?

Project Value	Project Cost (w/o land)	Hurdle Rate
$36,000,000	$25,000,000	20%
$39,000,000	$25,000,000	30%
$50,000,000	$35,000,000	25%
$60,000,000	$43,000,000	25%

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:

$65.5million (5% cap)

costs (before land):

$42 million.

land value at (30% hurdle)

$8.4 million

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:

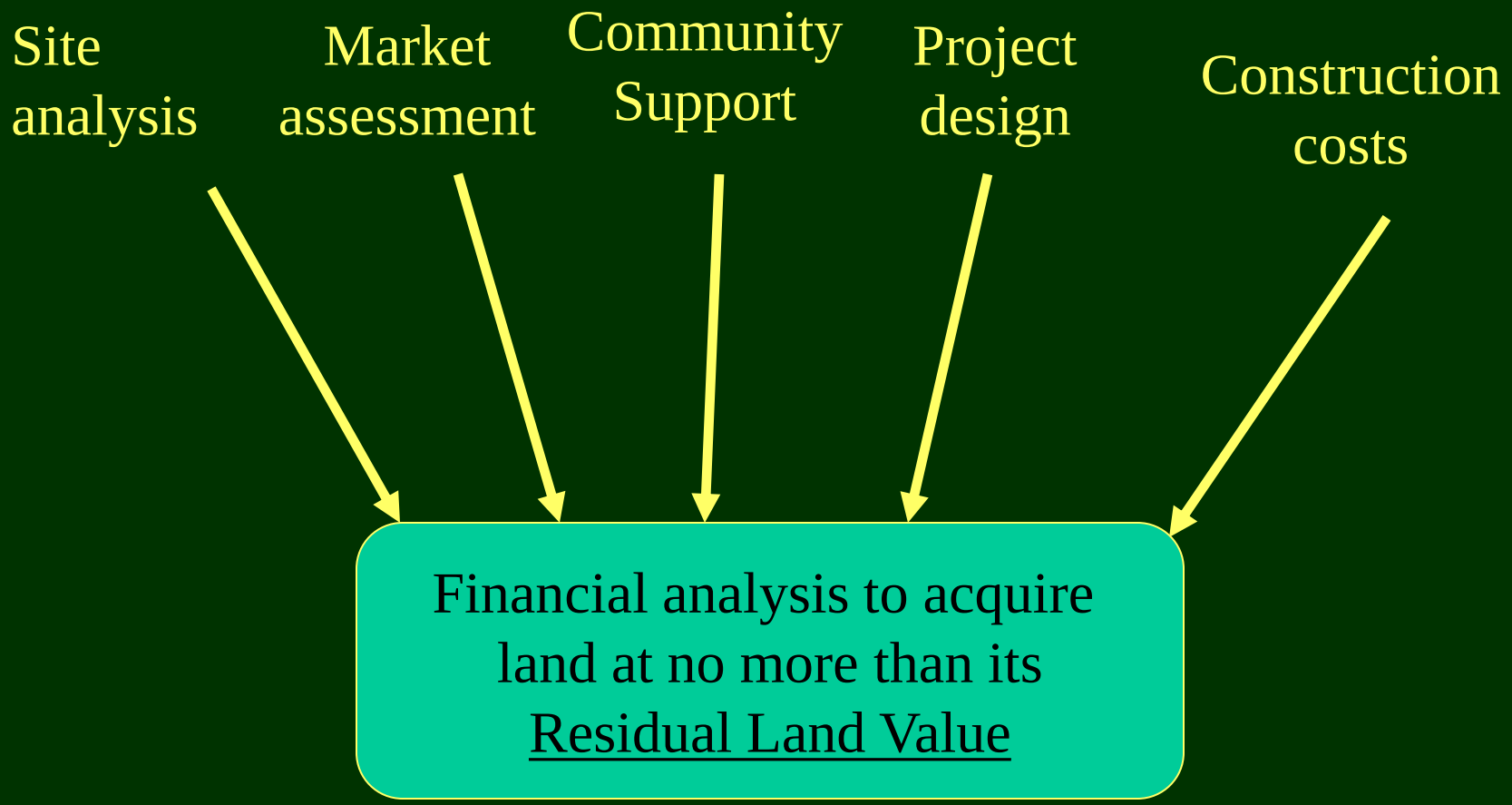
- Long and costly pre-development?
- Longer construction period?
- Higher market risk?
- High land deposit payments during pre-development?
- Higher city development fees?
- Land as “equity”?

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 other risk issues do you need to evaluate in acquiring land?

The six focus areas of project management and due diligence

Shape the land acquisition terms to the information



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—
  - Potential costs
  - Ability to proceed
- Before and 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, amenities, cost and value

- More is not always more.
- Understand cost and value.
- Foster relationship between the architect and contractor.

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:

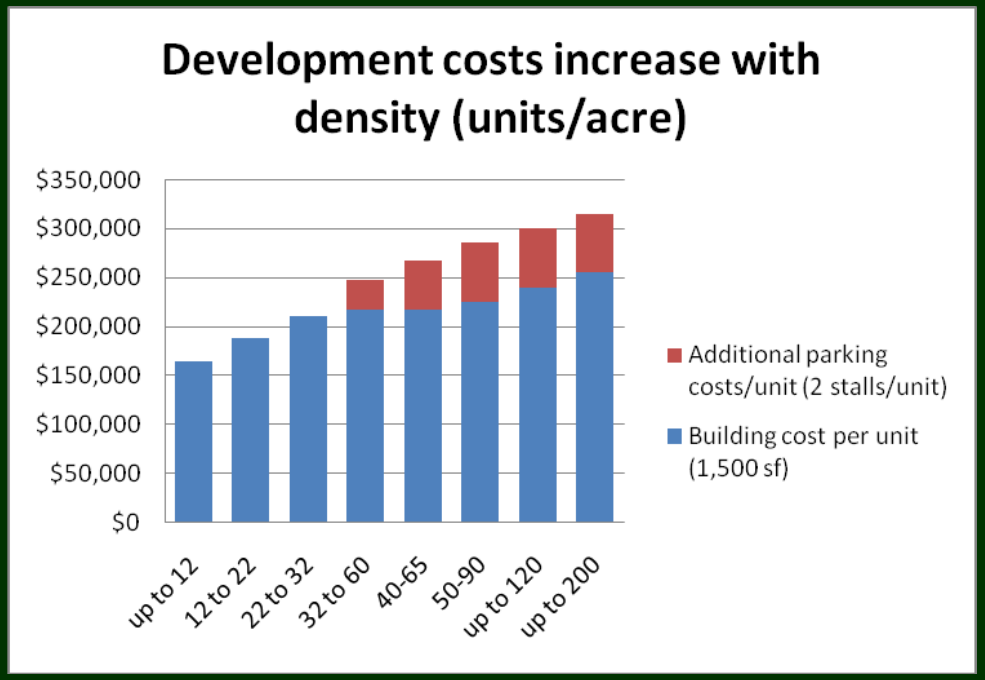
1. Building costs
2. Site Development (demolition, grading, utilities and landscaping)
3. Parking (may be included in building for some types of projects)
4. Connection and impact fees
5. Offsite costs such as traffic signals or road improvements
6. Design (architecture, engineering, consultants, etc)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

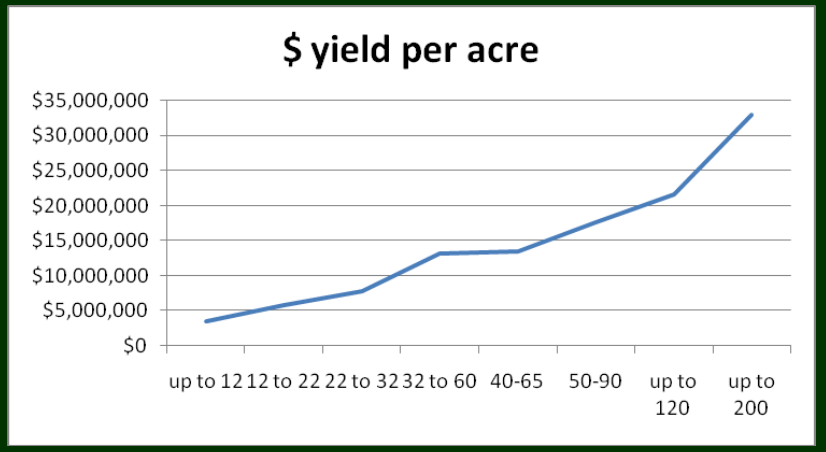
DO NOT LUMP COSTS!

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

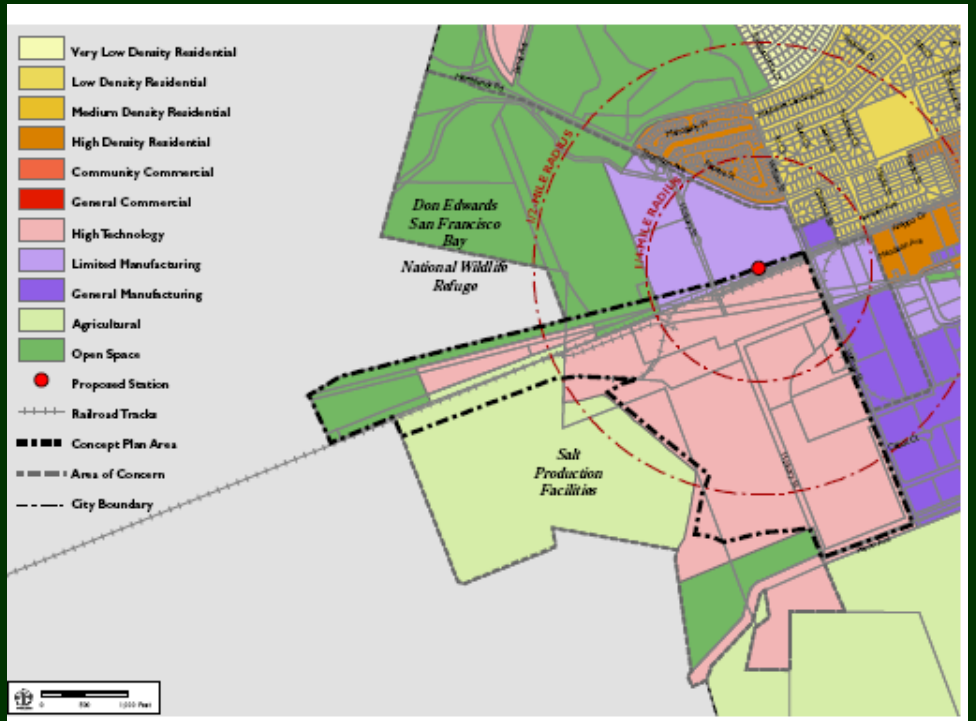


Figure 3-7: Area Two zoning designations as of 2007. Source: City of Newark GIS information.

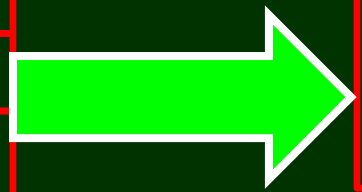
Key elements of a successful land acquisition

Discipline: negotiation, due diligence, validation and contingencies

Market value (validated)

Cost estimate (validated)

Hurdle rate reflecting blended cost of capital



Residual land value based on maximum supported investment

Six steps

1. Look for sites: investigate and identify those with promise

2. Preliminary analysis on promising sites

3. Begin negotiations with owners

4. Make an offer—Letter of intent (LOI) (could take awhile)

5. Execute a purchase and sale agreement (PSA) allowing a period of due diligence.

6. Conduct the due diligence process prior to escrow deposits becoming non-refundable if you decide not to proceed

1. 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.

1. 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.

2. Preliminary analysis of value

- Six part analysis on promising sites.
- Identify the areas of uncertainty and do more research.
- Exercise judgment about market, construction and entitlement risk.

3. 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.

4. 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 pre-requisite to the attorneys negotiating the purchase contract.
- Provide a reasonable time to execute the contract.

5. 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.

5. 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

6. 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)

Item	Cost
Soils, survey, title and environmental	$20,000
Market Analysis	$7,500
Preliminary project design	$10,000
Determine entitlement process and likely conditions	$7,500
Pre-construction services	$5,000
Total budget during refundable period	$50,000

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

EASY

Basket 2
After site control

Entitlement, non-refundable (hard) deposits and design.
Time is not your friend

HARD

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.

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 un-necessarily.
- 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?