Investing in (Re)Development

Development Process

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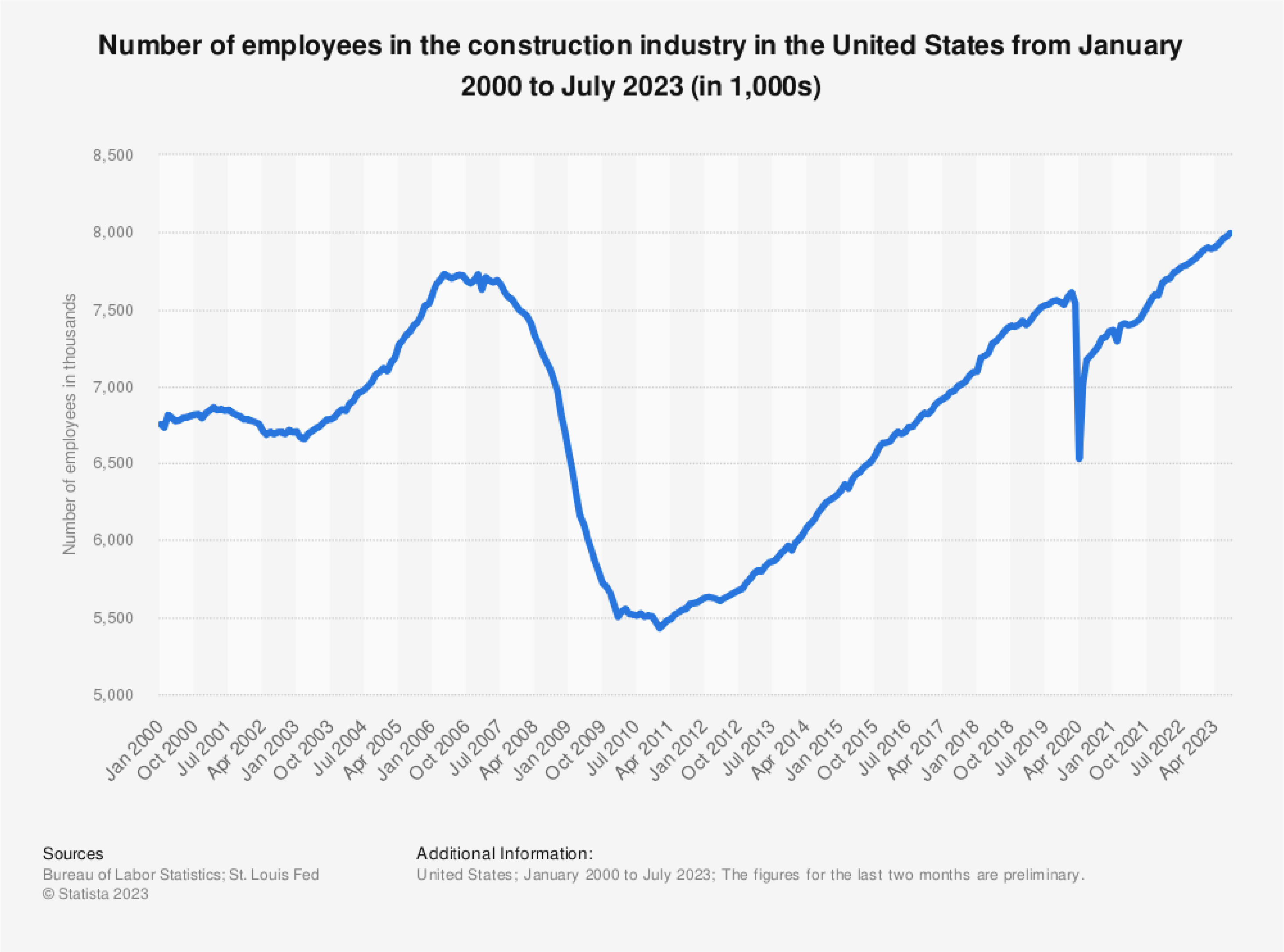
UCONN

1 Introduction



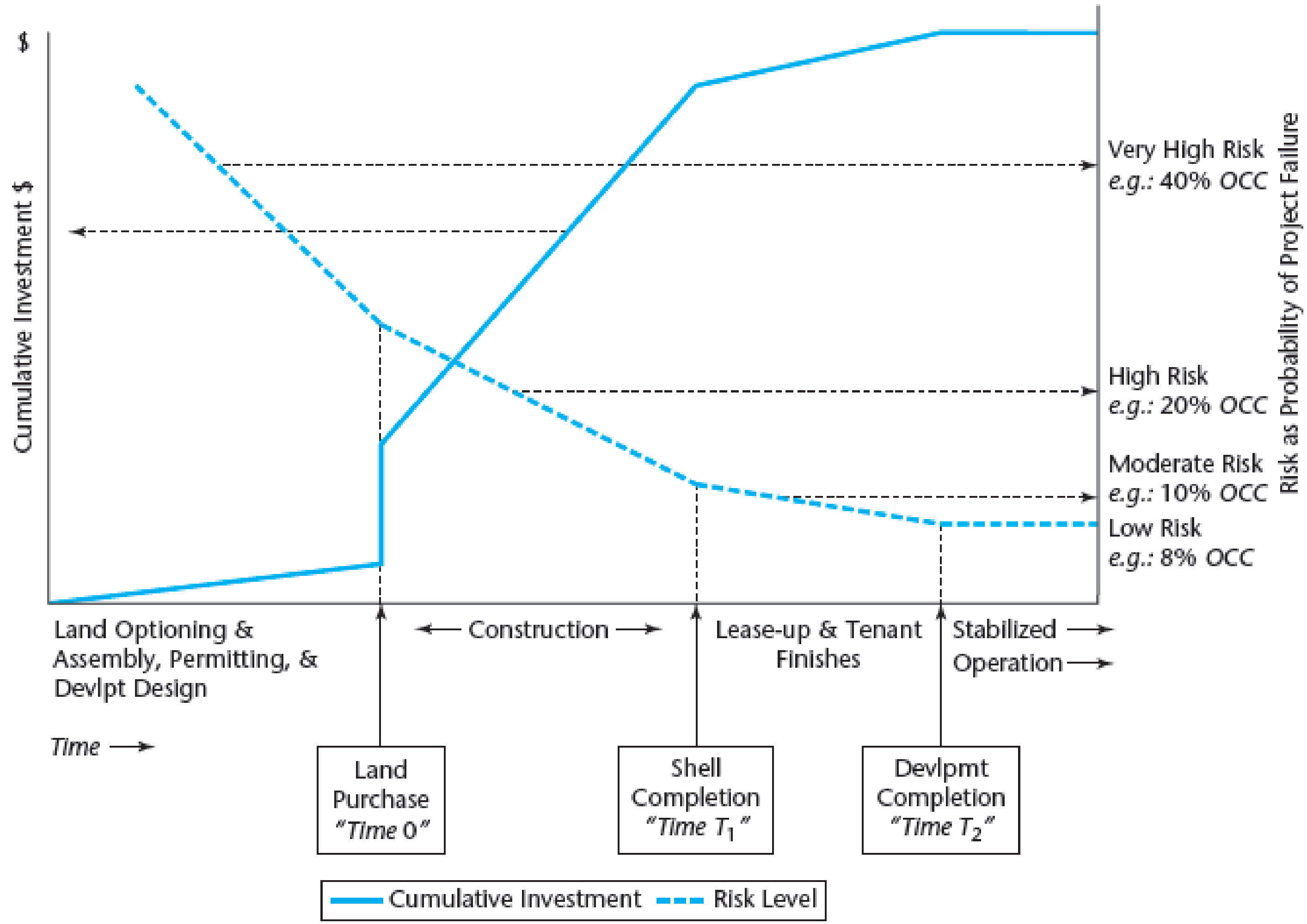
1 Introduction

What are we going to do during this class:

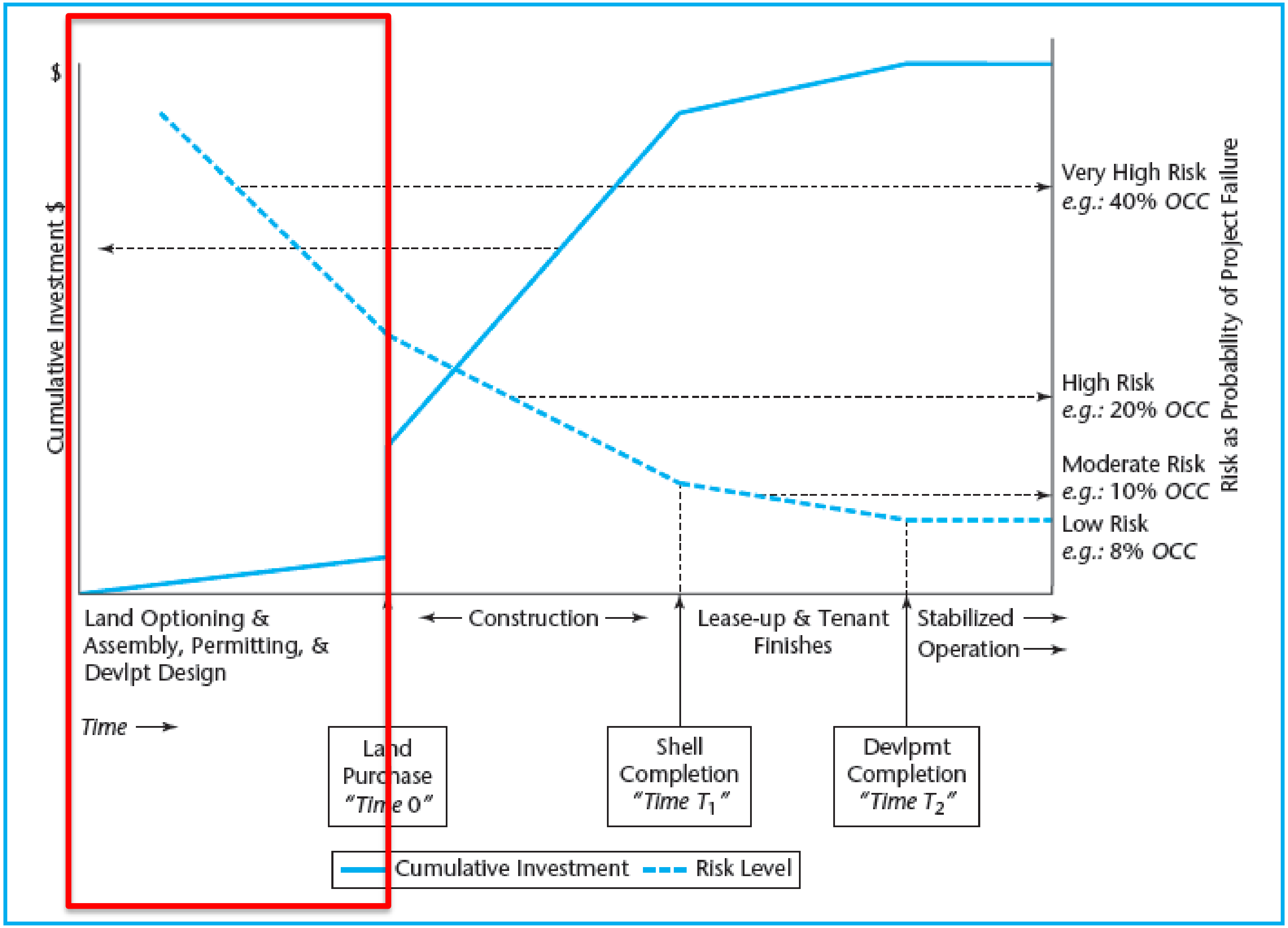
- Development is very important for many reasons.
  - Housing alone contribute 17% tot total GDP, mostly via renovations and developments.
  - You can actually add value with developments!

- Today we will look at the development process in overview.

The four stages of development



The four stages of development



Highest and Best Use

- Graaskamp famously that development can be described by two scenarios;
  - There is a site looking for a use.
  - There is a use looking for a site.

- With the first, you already own a piece of land, and you are looking for the HBU of that site. Thus, the main focus of such an exercise is the find HBU, etc.
- The second mostly occurs when a developer has a special expertize, like biotech space or senior-oriented housing. We find a lot of retail specialization in the real world. In this case you have to find to perfect location (demand-wise and competition-wise) for your new property.

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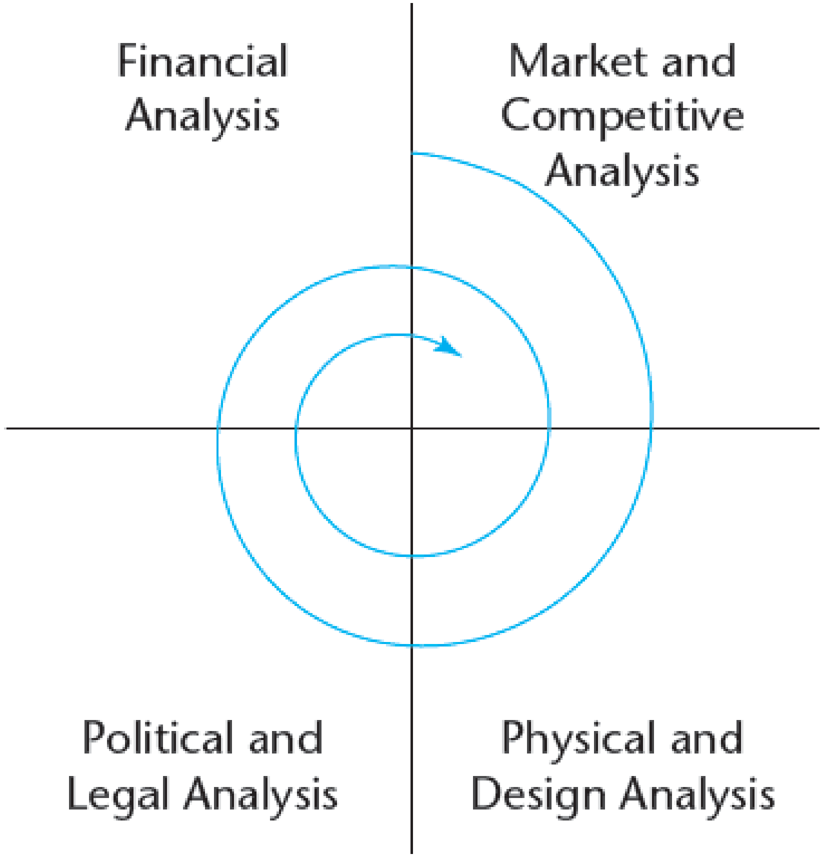
Site looking for a use



Site looking for a use

- Development will cycle through analysis from at least four different disciplinary perspectives;
  - **Urban economics.** Knowing the real estate space market.
  - **Architectural/engineering.** Physical analysis.
  - **Legal/political**. Think of zoning restrictions, etc.
  - **Financial economics.** Knowing the real estate asset market, and the borrowing market.

- Obviously, our focus is on the feasibility of developments. However, development is very tricky and needs input from multiple disciplines, and one good entrepreneur to put it all together!

Site looking for a use

General flow:

- Find the Highest and Best Use of a plot of land.
- Make a design and get all necessary permits.
- We are going to discuss;
  - The cost-side. Known as the **construction and absorption budget**.
  - The benefit-side. Also known as the **operating budget**.
- In order to know how much the property will sell for, you will need to do a DCF of the finished property!
  - However, it will only be finished in a year or two. What to do?
- Purchase (or option) the land (assemble) and find a limited / money partner.
- Find as many tenants as possible.

Cost of Construction

- We typically divide construction costs into two subgroups;
  - **Hard costs.** Direct cost of the physical components of the project, like building materials and labor.
  - **Soft costs.** Basically, everything else, like design, legal and interest rate on the construction loan. (I.e. financing costs.)

- Where the land acquisition cost or opportunity cost of land is placed depends on who you ask.
  - It is also sometimes a completely separate item to make it even more confusing…

Cost of Construction

Hard costs

- Land cost*
- Site preparation costs
- Permits
- Contractor fees
- Management and overhead
- Materials
- Labor
- Equipment rental
- Tenant finish
- Developer fee

Soft costs

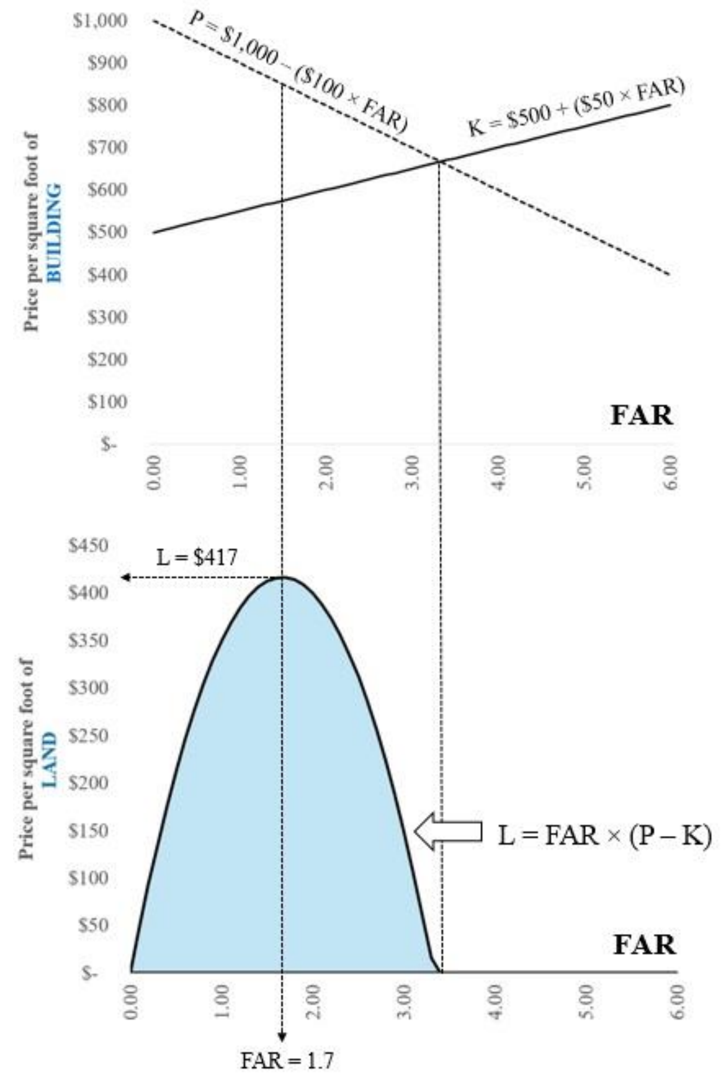
- Loan fees
- Construction interest
- Legal fees
- Soil testing
- Environmental studies
- Land planner fees
- Architectural fees
- Engineering fees
- Marketing cost
- Leasing commissions

Cost of Construction

- Other than costs associated with constructing the physical asset, there are also so-called **absorption** or **lease-up cost** for income producing properties.
  – This absorption budget is necessary when a project is built at partially **on spec**. In other words, the property was not pre-leased at the time of the development decision.

- You need an absorption budget until at least;
  – **Property-level;** current building is break even on a current cash flow basis.
  – **Financial-level;** until the building is at or near its expected long-term occupancy level. Only at this point is the property “stabilized” (meaning it has the expected risk/return profile). This is also the moment you can get a permanent loan.

Finding FAR

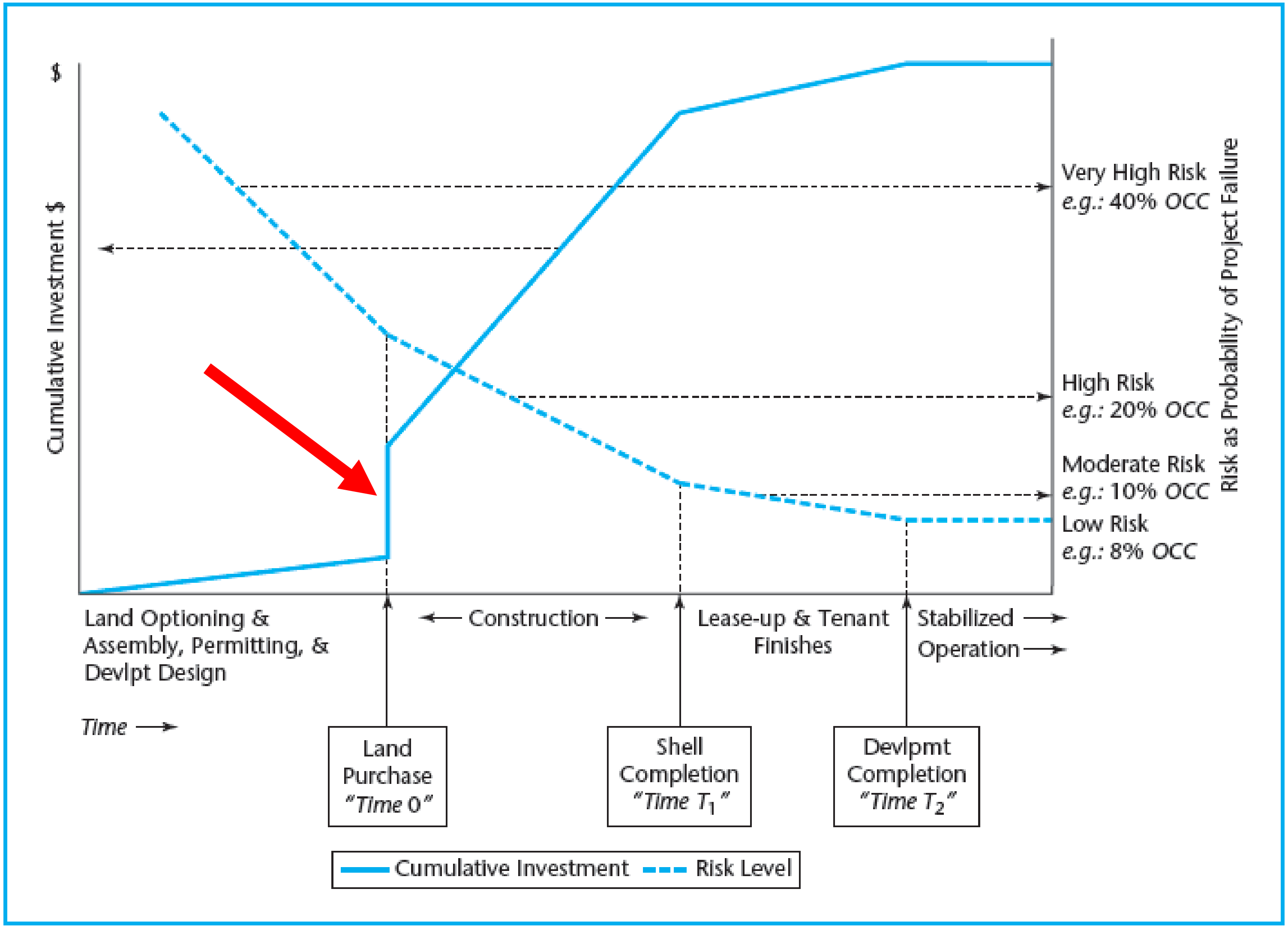


$1,000
$900
$800
$700
$600
$500
$400
$300
$200
$100
$-
Price per square foot of BUILDING
P = $1,000 – ($100 × FAR)
K = $500 + ($50 × FAR)
FAR
0.00
1.00
2.00
3.00
4.00
5.00
6.00
$450
$400
$350
$300
$250
$200
$150
$100
$50
$-
Price per square foot of LAND
L = $417
L = FAR × (P – K)
FAR
FAR = 1.7

Stage 1: Preliminary state

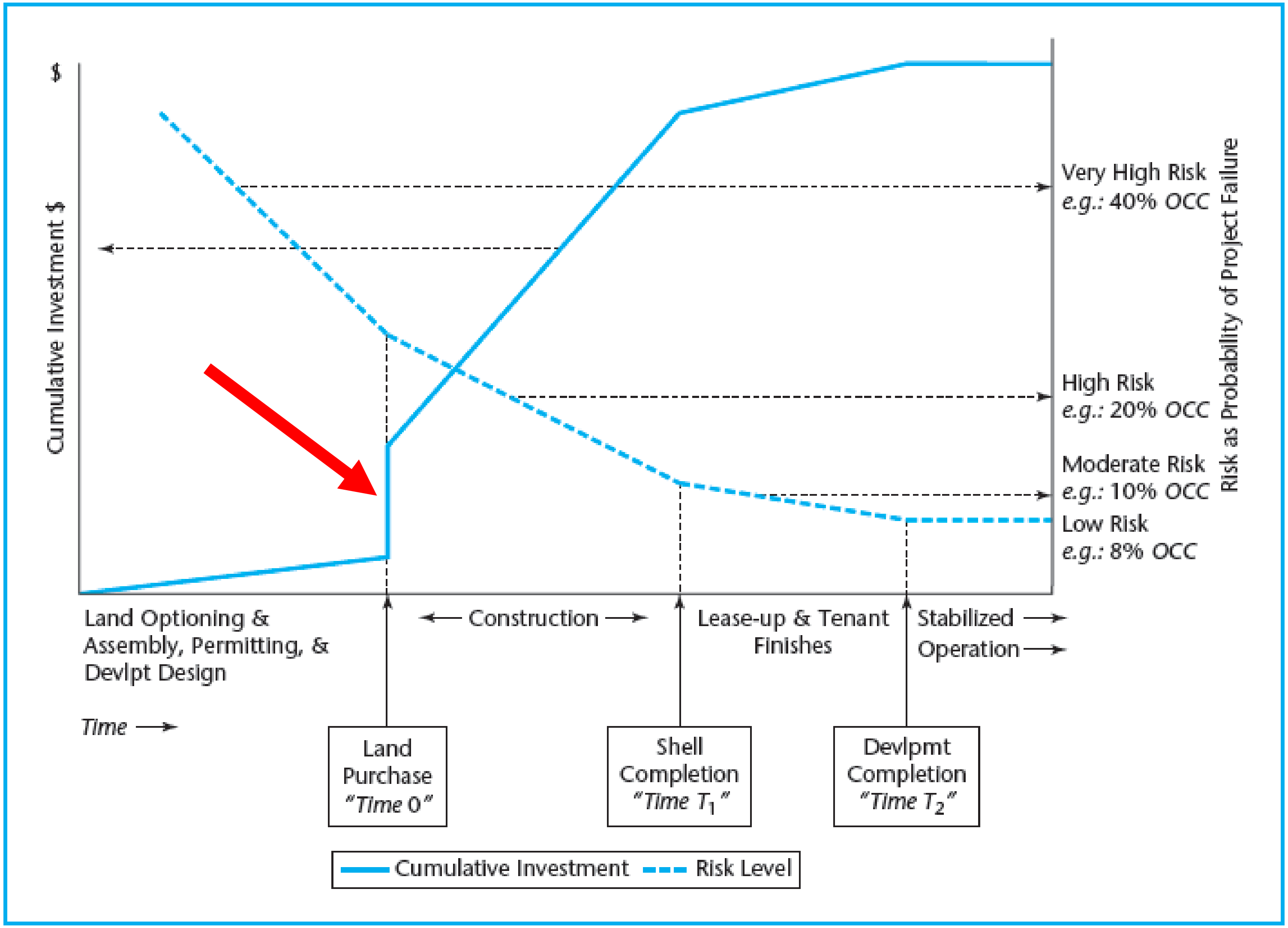
- Most creative and entrepreneurial time of the project!
- This phase of development can include;
  - Optioning and assembly of separate land parcels or infrastructure requirements.
  - The design of the project.
  - Doing a Highest and Best Use analysis of the project.
- This phase is characterized by the highest degrees of iterations between the disciplines described before.
- This phase is where the most value is created! **It is also the stage where you have the most risk** (it is basically land speculation), even though the invested amount is relatively small.
- At the end of this stage, you have the right to start construction.
- This phase can take decades!

Intermezzo: What happens here?



Intermezzo: What happens here?

The land is bought here!

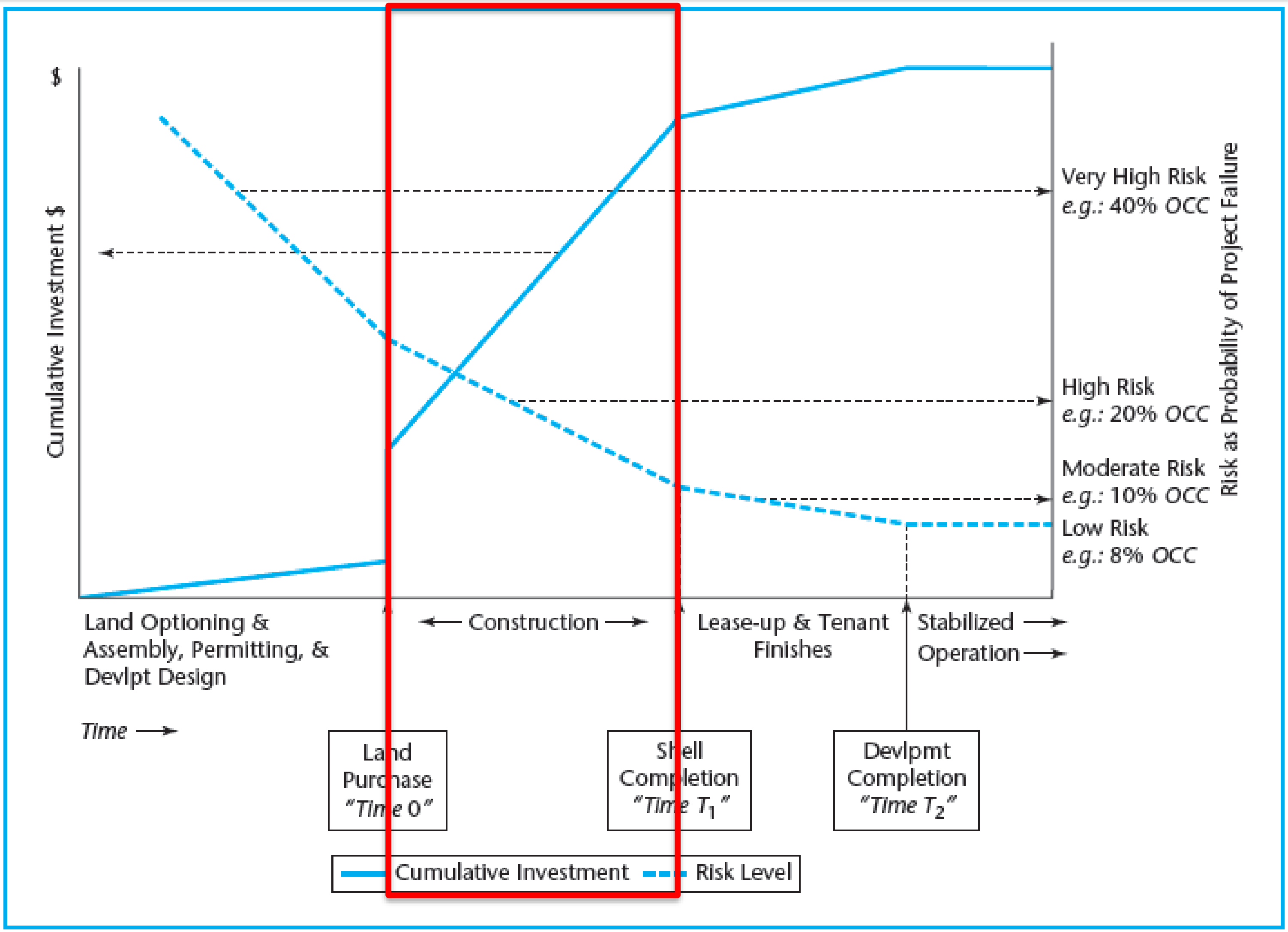


Partnership structure

- General partner (the entrepreneur) needs a limited partner for two reasons;
  - The GP simply does not have the money.
  - The bank (for construction loan) requires collateral, something a GP typically doesn't have.

- The deal is usually structured as a **waterfall**. This works;
  - Less risk for the LP. It gets a preferred return.
  - The GP supervises the development process and get compensated for this.
  - The GP can get huge returns and is therefore incentivized.

The four stages of development



Stage 2: Construction

- This is the moment were the bulk of the capital expenditures take place.
- Here you pay for the entire construction cost of developing the site.
- This phase is risky for two reasons;
  - In many/most cases, the building is leased-up before construction starts. Thus, it is not known for certain what the occupancy will be. (A space market risk.)
  - Development investments inherently contain "**operational leverage**", even if there is no loan, because you **have to pay the construction costs**, no matter how much the property is worth at completion.
    - Suppose construction costs are $70M, and you bought the land for $20M, and the present value of the constructed property is $100M. What happens if this present value happens to be 10% less?

Cost of Construction Loan

- As we noted earlier developments are financed by a temporary construction loan.
- You typically **do not pay interest** while the development is underway.
- In contrast, you pay back the principle and **the full accrued interest** after the loan is refinanced to a permanent loan.
- A construction loan is typically not a lump sum amount, but rather a maximum is negotiated, and as the construction moves forward, funds are **drawn out**.
- The construction loan provider, typically will check the development status during the process.

Cost of Construction Loan

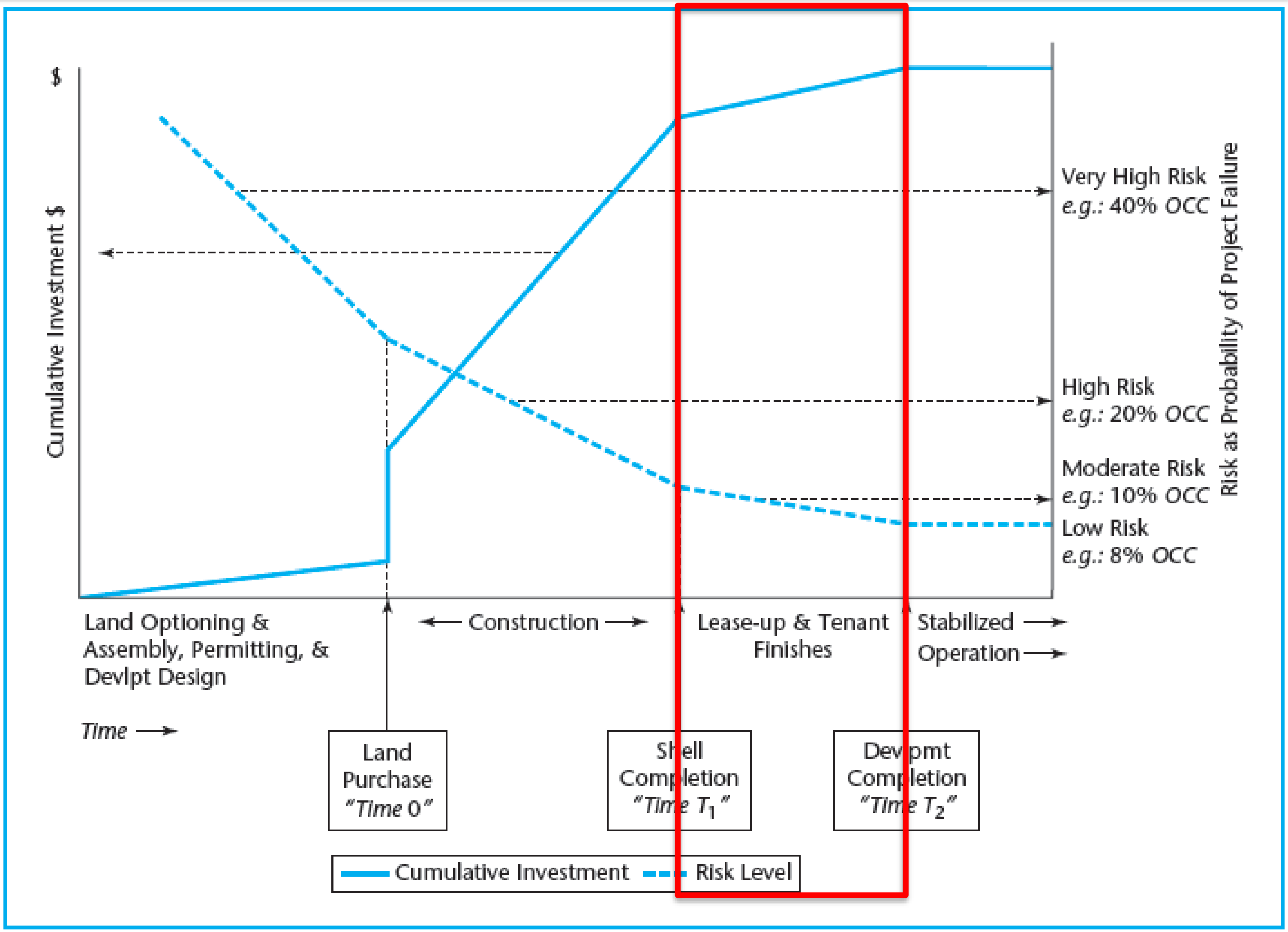
- Say you have a loan with 8% **annual** interest.
  - Thus monthly interest is 8%/12.
- The new loan balance increases because the principle is not paid.
- At the end, the new loan balance is $2.78M, whereas the withdrawn amount is $2.75M. The difference is the accrued interest.

Month	New Draw	Current Interest	New Loan Balance
1	$ 500,000	$ 3,333	$ 503,333
2	$ 750,000	$ 8,356	$ 1,261,689
3	$ 1,500,000	$ 18,411	$ 2,780,100
4	and so on		

Cost of Construction Loan

- The lender typically checks whether or not all previous work has been done.
  - For smaller project just showing the receipts of all subcontractors is enough.
  - For bigger projects, the lender might send inspectors.
- There is always a contingency budget of around 5-10%.
- The construction lender, also typically requires that the developer already obtains a commitment in advance from a permanent lender.
  - This is also why the permanent loan is sometimes referred to as a **take-out loan**.

The four stages of development

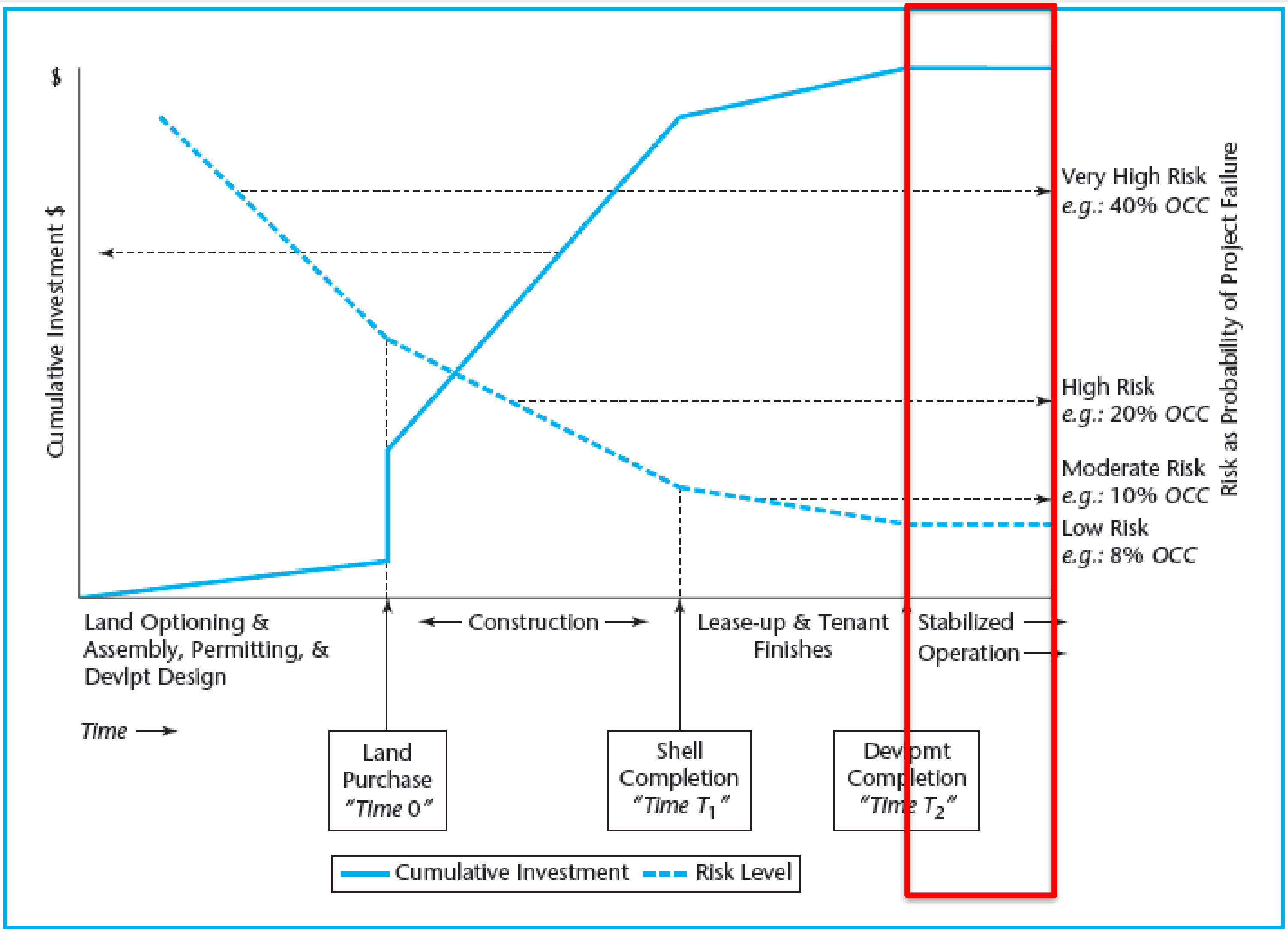


Stage 3: Leasing up & Tenant Finishes

- This stage starts when the outer shell is done.
- The inside can be finished.
- However, it is quite common that (in case of long-term leases) the future tenants are involved in finishing up the inside.
  - Both tenant and developer can pay for such finishes, it really depends.
- Less capital needed, and also less risky by now.

- Together with the construction phase, both phases represent the development project.
- The development can take several years.
- Sometimes, with multiple buildings for example, this phase itself might be subdivided into multiple stages. Flexibility!

The four stages of development

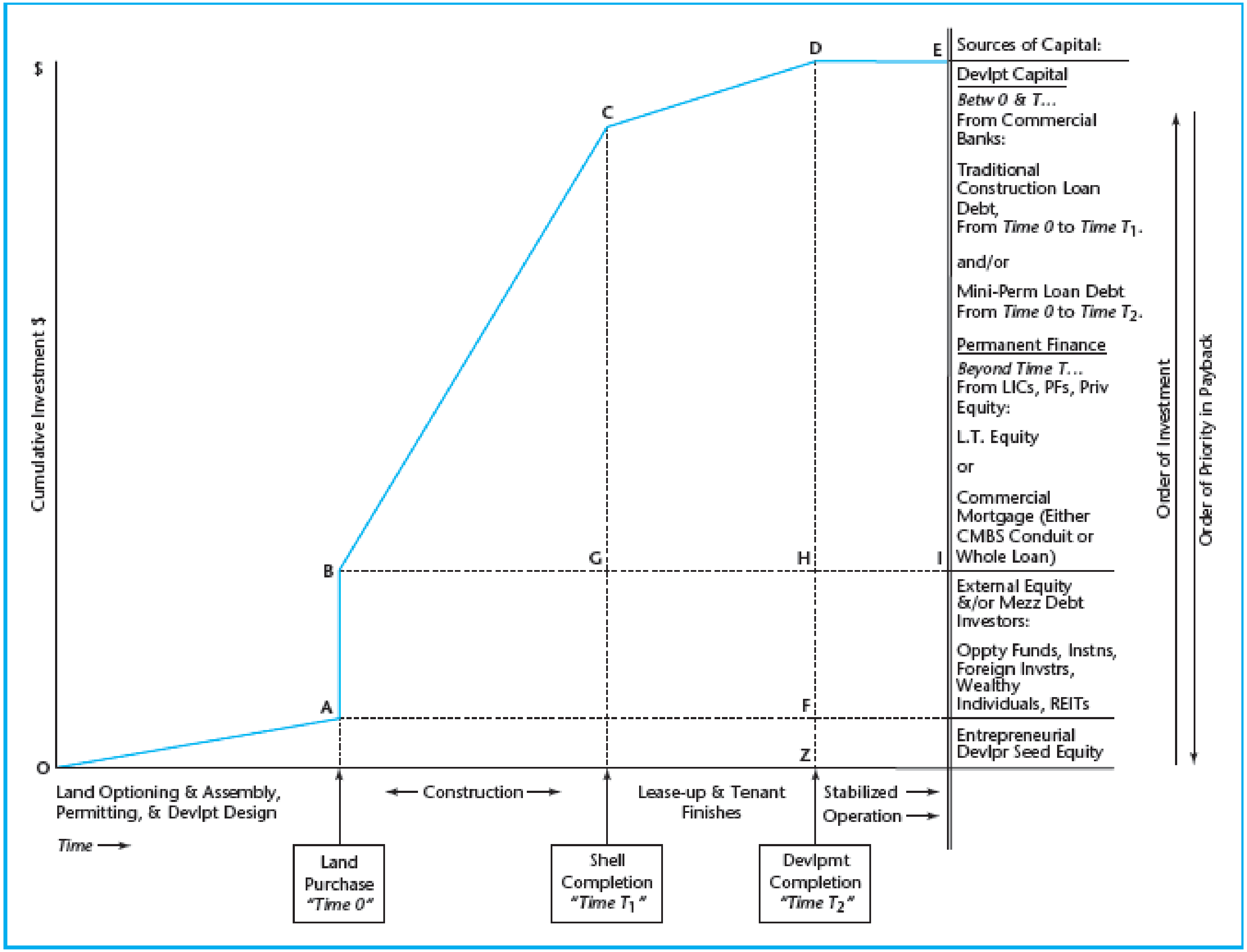


Stage 4: Stabilized

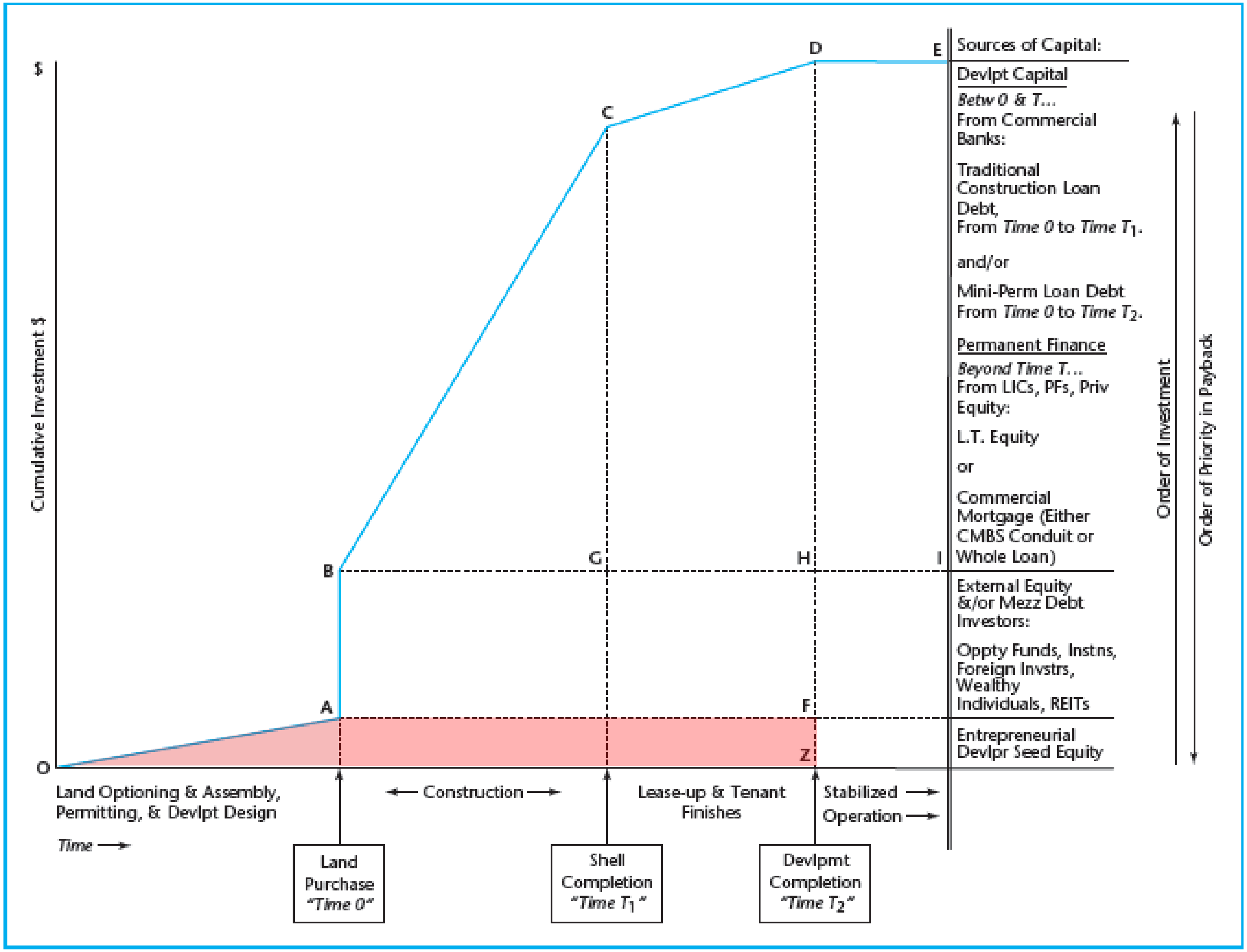
- At the end of the development, we have a stabilized property.
- It now operates at its long-run steady-state level of profitability.
- Usually, this means recapitalization;
  - Different investors are in the market for such low-risk property.
  - The construction loan will be retired, by replacing it with a "permanent" commercial mortgage on the property.

- Starting from now, we can use the tools we developed earlier to do our investment analysis on the existing property.

Sources of Debt

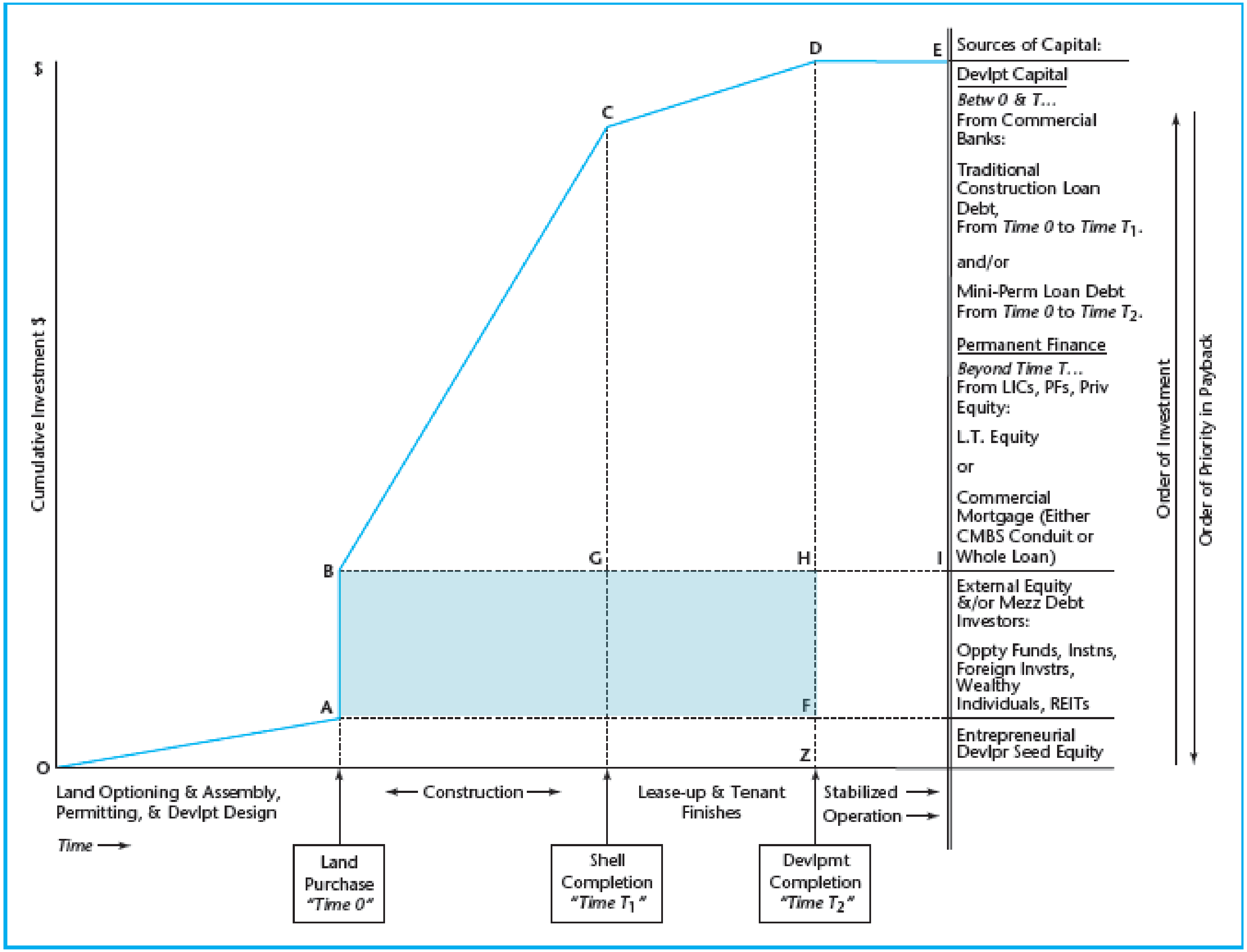


Sources of Debt



Entrepreneur's money

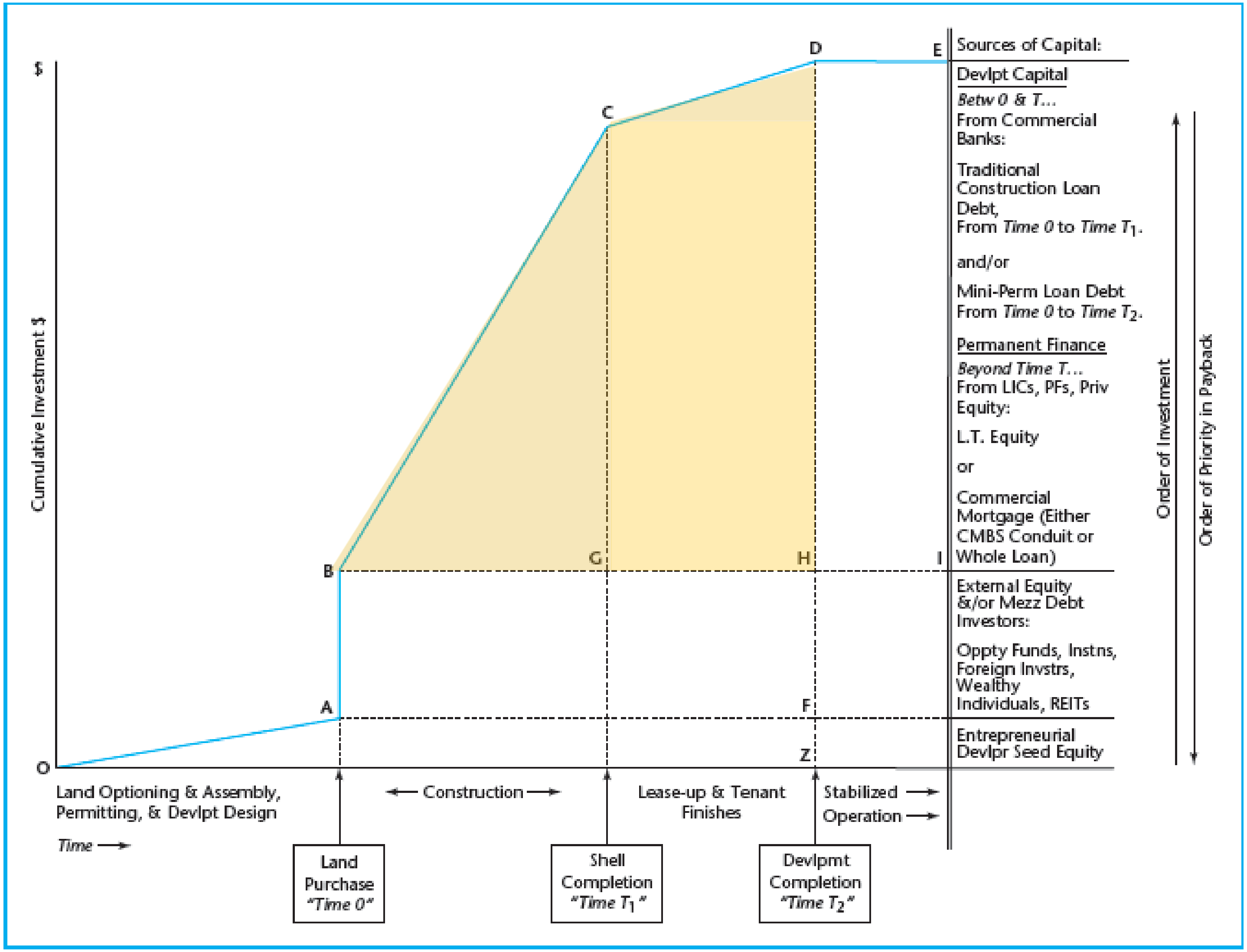
Sources of Debt



Money partner's money

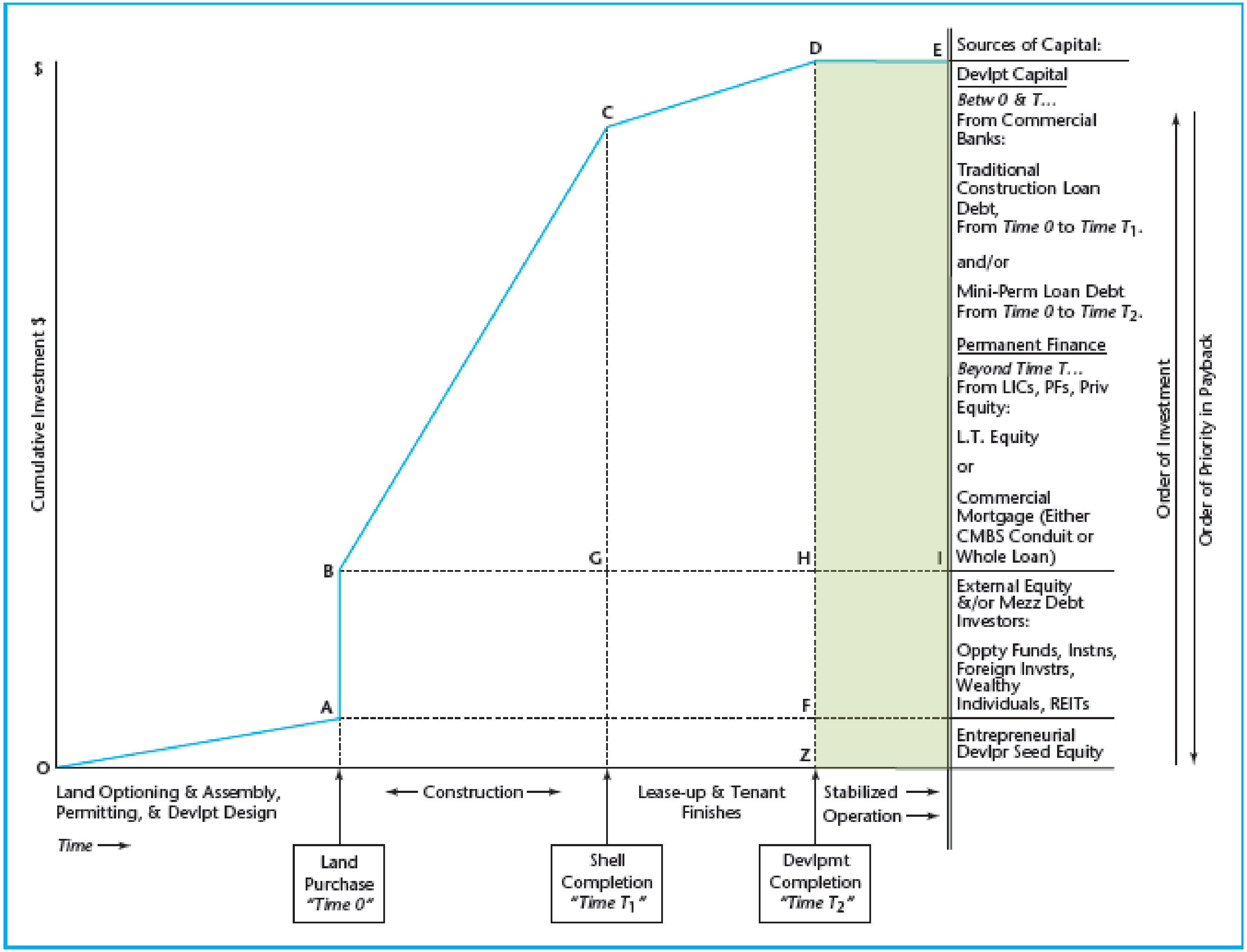
Sources of Debt

Construction loan



Sources of Debt

Sold to end user.



Sources of Capital

- Even though this course is not about debt financing, it is important from the development workflow point of view to understand where the capital comes from. We identify three stages;
  - First, we have the seed equity from the entrepreneur starting the project in the preliminary phase. It is a relatively small amount, but with a high return requirement.
  - Next, we find that “money partners” / Join Venture partners jump in, like opportunity funds, financial institutions (like pension funds) or public real estate firms, in order to **buy the land**. The entrepreneur can also completely fund this part itself. Sometimes even “mezzanine debt” is used.
  - During the construction, you take up a construction loan.