

Land Acquisition and Development Finance Part IV

In last month's "Learn" article, we discussed tying up the land and a more in depth formal due diligence process. This article will discuss Development financing.

DEVELOPMENT FINANCING

Financing your land development projects is a key component of running a business. In recent years this task has become one of the more challenging and complex aspects of land acquisition and development. Traditionally, your first source of funds to purchase land is personal equity invested in the company and retained earnings. Much of the day-to-day operations of the building or development are funded by your personal equity investments and the short-term credit of the vendors. However, when embarking on a land development project, the construction of developments requires more money than your own resources.

Land acquisition and development financing typically comes from any of the following three sources:

- Debt financing
- Private financing
- Public financing

LENDER FINANCING

With over 15,000 institutions in the US, commercial banks handle a significant portion of real estate lending. They buy a wide variety of assets, ranging from short-term government securities, to long-term business loans and home mortgages.

Depending on its business focus, a bank may offer debt financing to support any or all of the land acquisition and development process. There are three financing phases in the process, each financed separately. They are:

- Land acquisition debt financing used to secure the purchase of raw land
- Land development debt financing used to build the subdivision improvements, earthwork, sewer, water, streets, etc.
- Construction debt financing used for construction of models and homes for sale

Despite the fact that financial institutions have become more specialized, major lenders often finance more than one phase of complex projects and one lender can finance all three

phases of development. Land acquisition and development financing are often combined. Regardless, each phase presents unique challenges and risks.

Land Acquisition Debt Financing

The land development business is risky because it tends to generate little cash. Raw land may also be difficult to resell if a project fails because it may reduce its value as collateral. As a result, there are few major lending institutions that are involved in land acquisition financing and most of it comprises a combination of bank financing and developer equity. The institutions that finance raw land purchases typically rely heavily on your credit worthiness for assurance of payment. They often approve them only for their strongest customers or for those who have entitlements to develop the land and alternative sources, other than sale or development of the land, to repay the loan. The proportion of their real estate loan portfolio that can be used for land acquisition is restricted. They also provide no more than a 50 to 60 percent loan-to-value ratio funding.

Additionally, because your ability to repay a development loan is dependent on the successful sale of the lots, a lender must be satisfied that you will be able to sell enough lots fast enough to pay off the loan. Toward this point, appraisals can have a critical impact to securing financing. The federal government stipulates standards that appraisers must use. These standards require discounting the appraised value to adjust it to a present value. The discount, usually around 15 to 25 percent, results in a land value equivalent to a "bulk sale" purchase. A bulk sale is a price a single purchaser would pay to purchase the land for cash. This price allows for your overhead and profit earned by selling the lots at a retail price. After discounting the land and factoring a time value and velocity for a sale, the appraisal may be discounted up to 75 to 80 percent of the retail value. If the lender only lends 70 to 80 percent of that discounted appraised value, the amount the lender can actually lend in a transaction is severely restricted.

Addressing this issue early avoids undesirable project financing surprises. It is important that the appraiser understands the market, velocities, and appropriate discount rates for the local market that is being appraised. While federal regulations require banks to order the appraisal, you can ask the lender who it uses and work to educate the selected appraiser. Supply the most accurate and favorable information about your project in your loan package, including market information, costs, projections, comparable sales, and your retail house product pricing. You don't want the appraiser to have to work any harder than necessary to find this information and fairly appraise your project.

Land Development Debt Financing.

Once land has been acquired for a project, you obtain land development financing. This financing covers the following activities:

- Site preparation
- Installation of infrastructure (streets, sewers, etc.)

- Engineering and consultants
- Architect fees
- Zoning
- Other soft costs

Most land development loans are a first lien on the property and are short-term. Rates are generally be one to two points above prime rate. Check around and try to get the lowest rate. Again, lenders take high risks when financing raw land development. If the project falls through, the forecasted increase in land value will not be realized. Therefore, the lender carefully scrutinizes the credit worthiness and project potential and takes specific steps to minimize risk. Lending by parcel, developer backing, and repayment procedures are three common risk management examples in lender land development financing.

Parcel Lending. If you subdivide the raw land, lenders may approve loans for each subparcel separately. This is true because land loans are riskier than construction loans since repayment of the development loan is contingent on the sale of the building sites.

Developer Backing. Construction loans are generally backed by a commitment from the developer to assume the loan if the product does not sell. Often this is in the form of a personal guaranty of performance provided by the principals of the developer's company.

Repayment Procedure. Repayment of land development loans is conducted via a "release price" procedure. Lenders specify a loan payoff amount required before the land can be cleared of mortgage liens, a prerequisite for you to sell the lot free and clear. The release price per lot is calculated based on the proportion of the project's total financing cost, represented by the lot price plus 10 to 20 percent. The use of 110 to 120 percent of the proportional share is required by lenders to minimize the risk associated with the development. It allows the lender to recapture the bulk of the loan before project closeout, which provides the lender with further assurance. In turn, you receive profit from the sale of the lots at the end of the development period.

Construction Debt Financing

A construction loan is used to finance improvements to the property, primarily the grading, drainage, streets, and utilities. Generally this type of loan requires collateral, usually the land itself assuming that you have sufficient equity value in the land. The lender will disburse funds according to completion of the improvements as the project is developed. Commercial banks make the preponderance of construction loans, leaving life insurance companies, syndicators and mortgage banks to pick up the rest. While land development financing is sometimes considered risky, construction financing is popular among lenders because of its characteristics. The appealing characteristics can include:

High Interest Rates. Risk and ongoing administrative burden generate the high interest rates and substantial loan commitment fees of construction loans.

High Loan-to-Value Ratio. Construction loans generally equal 100 percent of the total construction cost if you can provide adequate security.

Short Term. These loans cover the expected period of construction, usually from six months to three years. Payment in full is expected at the end of the construction period.

Timed Funds Disbursal. Funding is released as construction progresses, in a predetermined sequence. You pay interest on the funds disbursed and the lender's risk is reduced since the outstanding loan is matched closely to the value of the construction.

Repayment at Maturity. During the construction period there is no cash flow and no amortization on the loan. Repayment is made possible from the proceeds of long-term financing or from the sale of the residential units.

Construction lending and land development lending share a unique set of risks associated with the real estate market. First, loans must be based on estimates, projections, and judgments rather than facts. Lenders must assess the project's marketability, the accuracy of construction cost estimates, and the developer's competence—none of which is a known fact when making the loan decision. In addition, construction projects are subject to many external factors that can dramatically affect their success: These can include:

- Weather delays
- Unavailability of scheduled land
- Material shortages
- Environmental and regulatory barriers
- Changes in market demand
- Changes in interest rates

Lenders attempt to minimize these inherent risks in various ways, such as the nature and value of collateral, the method of funding of loan proceeds, and the method of repayment. For example, they conduct frequent inspections to verify that the work is proceeding according to plan and that the funds are being disbursed properly. Once the loan is made, the lender and developer must follow a very strict loan disbursement process. Funds are made available as work progresses. In addition, payouts are frequently authorized by the general contractor, but go directly to the subcontractor to assure receipt of funds.

Pension Funds

Pension funds, with their steadily growing trillions in assets, are another viable source of debt financing for established developers, only. In the past, only a small percent of pension funds have been invested in real estate. However, these funds have expressed an interest in real estate investments and they are becoming an increasingly popular option for large projects. A directory of the 100 top pension fund managers that manage 95 percent of the real estate assets of all pension funds can be found at www.internetreview.com.

Small Business Administration

The Small Business Administration is a governmental agency that insures a percentage of the loan that is made by a local lender. These loans can be made on a real property for business use. These loans have many restrictions and usually take a long time to process. The interest rate is often lower than the current market because the government is guaranteeing a portion of the loan. You can find a description of the programs available and their requirements on the SBA website, www.sba.gov.

PRIVATE FINANCING

Private financing falls into two categories: seller financing and equity financing.

SELLER FINANCING

Within the seller financing category, there are several options available for land acquisition. The most common purchase arrangement is 20-25 percent down payment with the balance financed through a land loan. The seller-financed loans most commonly include: subordinated mortgages, installment contracts, option agreements, and the partnering seller.

Subordinated Mortgage or Purchase Money Mortgage.

With a purchaser money mortgage, also called a purchase money trust deed, you purchase all or a part of the land by giving the seller a mortgage at transaction closing for a portion of the purchase price. The Seller in effect becomes the lender in the transaction. Typically you make a down payment of 10 to 20 percent of the purchase price to the seller. At closing you sign a note, secured by a mortgage lien, on the purchased property, for the balance of the purchase price. The mortgage term is generally short. Terms include balloon payments that are often used when monthly payments are set on a 20-30 year schedule. For example, the loan matures in 10 years with the unpaid balance paid as a lump sum at the end. The seller accepts your note for the unpaid price of the land secured by a mortgage on the property note, instead of cash.

Subordination is a key feature with this type of financing. Sometimes, the seller agrees to subordinate the first mortgage on the land to a subsequent construction financing lender and

the lender typically demands a first lien. In subordination agreements, the Seller's interest in the unpaid balance of the purchase, whether as a contract balance or mortgage position, becomes a second interest behind a lender who takes a first position. If the lender is not paid and chooses to foreclose on the property, the Seller must pay off the first position of the lender or risk losing the unpaid balance of the purchase price. Other times, a seller will not agree to subordinate his interest to a construction mortgage because the seller's position is high risk and his or her interest becomes the equivalent of risk equity. However, in circumstances where there is a high degree of trust and credibility between you and the Seller, it can be an effective method of financing.

Essentially, the purchase money mortgage offers financing with no amortization (no payment of principal, just interest only) or with the amortization delayed (no principal or interest payment until a specified date). It provides immediate financing and an investment for the seller secured by his or her property. This seller's position is high risk and his or her interest becomes equivalent to risk equity. In return for the financing opportunity, the seller receives a higher return from the buyer. However, it is in your best interest (no pun intended) to prepay the purchase money mortgage as soon as conventional financing is available. This lowers the interest rate thus creating a greater leveraged return.

Installment Contracts

In a land installment contract, also known as a land contract, the owner retains title (and possibly possession and use) of the land until the purchase price is fully paid; however, you gain immediate possession of the property. You can also use these contracts to arrange a phased release of land portions, with 20 percent of the land held by the seller until full payment of a three or four-year contract. If the seller retains possession, other present uses may continue. This gives the seller security and enables you to obtain release of at least a majority of the land.

In the installment sale, you make periodic payments to the seller with interest on the unpaid portion of the purchase price. This continues until you pay the entire purchase price and obtain the deed. This is a nonrecourse contract meaning that, in the case of default, the seller normally cannot force you to buy the remainder of the land. If problems with local municipalities and utility officials arise, these contracts usually offer an abatement of periodic payments on the land contract as an option. Also common, you can retain the right to pay off the outstanding balance at any time to facilitate land development plans.

According to the IRS regulations under a qualified installment sale, the seller can realize a tax benefit by spreading out the tax consequences of a sale over a period of time. The seller is taxed only on sales proceeds in the year they are received. The purchase price must be paid over 2 or more tax years. (As a result of the Revenue Act of 1987, the installment method is no longer available to dealers in real property, but sellers of real property who are not dealers can still use the installment method.)

Seller as Partner

You can also become a partner with the landowner to finance the land purchase. For example, the landowner can put up the land, while you put up the skill of platting the site

and obtaining all the necessary approvals. After the plat has been approved and all appeal periods have expired, then the exchange of money can occur. The price for the land can be fixed or adjusted up or down for such provisions as the length of the closing date, the number of lots achieved or the actual costs of development.

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