

Land Acquisition and Development Finance Part I

Introduction.

Land Development is both an art and a science. It is an art that builds on your creativity, instincts and vision to transform an idea from concept into reality. As a science, it systematically progresses through a series of activities to accomplish a successful outcome – a new development. In this article, presented in six parts, we will discuss the Land acquisition and development finance process:

- Market analysis
- Finding the land and the preliminary investigation and financial analysis
- Tying up the land and formal due diligence
- Development financing
- Financing structures using OPM (Other People's Money)
- Organization business structures and selecting a lender

The process builds from market research and analysis that reveals buyers' needs and market opportunity. Developers find the land that supports the market opportunity and investigates its potential for development and improvements. Land that offers a match is temporarily tied up until formal due diligence can be completed. The development team creates one or more site plans that illustrate the actual use and layout of the property. Once the presiding governmental entity approves the proposed development, developers initiate contracts and actual site improvement begins. Throughout the process, developers obtain land acquisition, development and construction financing. Each step plays a vital role in the success of a development. A developer may actually start anywhere in the process. Land development doesn't necessarily work in a linear fashion. For example, he or she may already own raw land and desire to develop it. In any case, successful development means returning to preceding steps before completing the project to ensure it targets viable market opportunity and involves feasible improvements.

Market Analysis.

Many builders see land development as a logical step in their career and business growth. No doubt, experience as a homebuilder is a relevant preparation for the endeavor. But, before you take that step, you need a complete awareness of the market in which you plan to do business. Before you purchase and develop the land and the market, you must know that particular market. Market analysis activities provide an enormous amount of information that is essential to accomplishing that task. The resulting information becomes a foundation for your land acquisition and development financial decisions.

Purpose of Market Analysis.

Before you purchase and develop land in a market, you must know that particular market. Market analysis activities provide information that is essential to accomplishing that task. The resulting information becomes a foundation for your land acquisition and

development financing decisions. Market analysis is conducted on a specified area, at a particular time to achieve multiple purposes, including to:

- determine project feasibility
- forecast sales rates (market velocity)
- provide insight to public and regulatory reaction to growth
- ensure the proposed product matches the land
- determine project designs
- provide the basis for a marketing plan
- provide documentation to support zoning and annexation permit requests

With the information provided by a market analysis, you have much of what you need to pursue land acquisition or development with confidence. It provides the information needed for planning land use, determining the most marketable product, establishing competitive pricing, and identifying niche opportunities. It also highlights any trends that are affecting the real estate market in the development area so that you can anticipate and leverage those trends.

Some developers have used a less extensive type of market analysis commonly referred to as “windshield analysis.” The phrase comes from a developer’s practice of driving through other active developments that are near the targeted area of future development. The developer uses his or her observations of what seems to be successful in these active developments to plan the type and location of a new project. However, the current homebuilding market has become increasingly more complex, making a windshield analysis approach less appropriate and too risky. The resulting observations cannot tell you with certainty whether other developers and builders in the market are really successful and profitable. In addition, decreasing development capital, increasing competition and government regulation, and changing population characteristics make these informal techniques less effective and raise the need for a more thorough and formal market study. Today’s developer recognizes that market analysis is much like homework that must be completed prior to taking the test. Failure to do the homework is not only inviting failure but will make every step in the development process more difficult. Risks of not completing a thorough market analysis can include poor site selection, difficulties securing financing, and ineffective development marketing, to name only a few. A thorough analysis is always recommended.

Market Analysis Process.

The market analysis process involves studying several areas of the market to form conclusions about the land development opportunities it presents. The study includes economic base, supply and demand, and buyer profile within the targeted area. These areas work together to identify a target market for your project.

Economic Base Analysis.

The economic base analysis focuses on the various economic influences on a market. It explores these questions:

- What are the trends related to the general health and stability of the economy? Is there growth or recession occurring?
- What are the area's biggest employers and what are the levels of employment or unemployment?
- Is there strong economic development activity and, if so, what is forecast?
- What are the current interest rates and how are they affecting financing activity – both short term construction and long term mortgage financing?
- What are consumer behaviors relating to savings and investment activities?
- How much income do consumers have to purchase housing?
- What price category sells the most?
- Which price category sells the least?
- Economic data, such as employment trends, population, age, and income distribution, allow you to evaluate the market opportunities.

Employment Trends

Employment trends in an area affect land development. New job growth drives housing demand (new and resale). For example, analysts estimate that for every 1.25 new non-farm labor jobs, a new demand for one housing unit is created. Thus, these trends can signal opportunity. They also indicate an area's stability and growth potential, and characterize the existing and future labor force. Employment trends point to the affordability of housing and the types of housing needed based on community income and lifestyles.

Population Data

Population counts and projections provide a basic measure of demand for housing within a defined market area. It stands to reason that the more people there are in an area, the more housing that is required. Population growth is the sum of natural increase and migration. Natural increase is the net sum of births over deaths. Migration can be positive or negative, depending on whether more people are moving in or out of an area. Market analysis always distinguishes between permanent and seasonal population so that market opportunities related to various seasonal fluctuations in population can be identified. For example, the growth of the farm worker population during peaks in the

agriculture industry or an influx of vacationing residents in good weather seasons flag opportunities for short-term rentals. Similarly, in the Sunbelt, there is a market for the homebuyer looking for a second residence in the winter.

Population data also points to the type of housing opportunities in the market. For example:

- Growth trends in multi-cultural markets may signal opportunity due to the influences of racial and ethnic preferences on housing demand and product type.
- Size fluctuations in age categories increase the demand for some housing and decrease it for others. A current breakdown and trend progressions can help determine the type of housing that may be needed and in what quantities.

Income

Different income brackets have different expenditure patterns, thus household income distribution helps you determine the housing affordability for a given region. As a rule of thumb, monthly mortgage payments of buyers should not typically exceed 25 percent of their gross monthly income, and no more that 33 percent of their income when added to other installment debt. Consider the economics in recent years when mortgage rates were low. Apartment renters were flooding the home buying market because the cost of buying a home was cheaper than rent. Given these guidelines of affordability, it stands to reason that higher and mid-levels have more expendable income for luxury items, higher priced goods, savings and investment. After figuring the housing affordability range for an area, you can make a comparison to the prices of homes already purchased. The results help you decipher whether homes are selling at, above, or below purchasing power of the area.

Supply and Demand Analysis

The supply and demand analysis helps you form conclusions about the need for your project in the market area. Opportunity in a market exists only when the level of demand remains high up through the point in time when your product goes on the market. You must determine whether you project will satisfy the demand, create a surplus, or address a unique niche in the area.

A comparison of the existing supply and vacancy rates with household growth projections provides a good estimate of the annual housing demand. If your analysis shows a low supply and high demand for a particular type of project you might proceed full speed ahead. However, in a situation where demand is high, you should also consider the potential for a market saturation in which the housing supply is nearing or meeting the area's demand and cannot justify more development. Similarly, if there are a large number of properties up for resale, this may reduce your opportunity in the area because it may devalue your project. Housing supply is made up of both new unsold and existing resale homes. New rental projects also draw from the demand pool. Thus your

analysis should research competitive subdivisions, current building activity, and the resale market in the selected geographic area.

Competitive Subdivisions

Regarding competitive subdivisions complete an inventory analysis on current new housing projects to determine:

- How many housing units are there, (include new subdivisions under construction since they will be building out during you process period)?
- What kind of housing units are available?
- How much the units are selling for on the current market?

To further assess your market, complete a more comprehensive competitive inventory that focuses on the supply of the particular product type you plan to put on the market. Visit competitive projects to gather the following specific information:

- Project name
- Developer
- Location
- Style
- Number of units
- Mix of units
- Sales start
- Units sold
- Price/lease rates (include rental rates and square footage)
- Amenities
- Options
- Future plans and schedule
- Lot inventory

Current Building Activity

Part of knowing the market's housing supply is staying abreast of the current building activities in the area. You can gather information through the local planning, building permit, and real estate board offices. The following five things are useful measures of current building activity.

- The number of building permits issued
- Absorption rates
- Vacancy rates
- Lot inventory
- Unsold or "spec" inventory

Resale Market

Regarding the resale market, your market analysis should provide information on the existing homes currently available for sale. You'll need to determine:

- How long homes are on the market before they are sold?
- What are the characteristics of resale homes?
- What are the asking and selling prices?
- In the most active areas, what are the product types and price ranges?

The MLS system supplies this information through your local real estate board. You can request reports.

BUYER PROFILES AND THE TARGET MARKET

Buyer profiles define the motivations, lifestyle, and preferences of socioeconomic groups within the market. Data in this area of research is based on the premise that people who share similar demographic and socioeconomic characteristics tend to live in neighborhoods with others who share similar lifestyles, product needs and preferences. This can be used to define the target market, develop the most marketable product, and ultimately increase project profitability.

Research about the buyer profile should answer questions regarding the targeted consumer market, their tastes and living habits. The data you gather helps determine product features, prices, and absorption rates for the planned project. The market analysis should also outline any anticipated changes in buyer profile of the area. This is done by a thorough investigation of any future development. For example, if a market analysis reveals that within the next two years several developments are planned it would be important to insure these would not dilute the success of your proposed development. If the market analysis reveals plans for a major shipyard to be built in the next two years, then you may have the opportunity to develop for a target market that includes lower-income laborers.

Market Analysis Consultants

If your company does not have the personnel to do the extensive research required, it may be best to hire an outside consultant to do the job. The best way to hire a good market analyst is by referral. Try the members of the local Home Builders Association for a reliable recommendation. Seek out those who have the appropriate specialty area. Then, once two or three prospects have been selected, check references and ask questions.

- Did the references find their work thorough and useful?
- Was the material produced in a timely manner?
- Did the client receive any bills above and beyond what was agreed upon?
- Was the analysis successful in obtaining the necessary financing?

Once you have hired a consultant, meet with the market research team to communicate the full scope of the new project and explain your information needs. It is equally important to

get all agreements in writing including costs, delivery dates, and types of and objectives of research to be conducted.

If you can't afford a market analysis consultant, then complete the steps of a formal market analysis process yourself. Depending on your or your consultant's familiarity with the market, the time to collect information, review and present can take four to six weeks.

The market study is a critical part of the land development process to both minimize risks and to obtain financing. It attempts to identify the need for a proposed residential development in a specific area. A good market plan can provide you with the best product possible for the market and provide you the best opportunity for success in you planned development.

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