Land Acquisition and Development Finance Part II

In last month's "Learn" article, we discussed a market analysis that becomes the foundation for your land acquisition and development financial decisions. This article will discuss finding the land and the preliminary investigation and financial analysis.

FINDING LAND (Site Selection)

With the conclusions that emerge from your market research and analysis in mind, your next task is to select land that allows you to pursue the identified market opportunities. There are many ways to locate land. The most common are advertised and vacant parcels, real estate brokers, mailings, government officials, and your personal and professional network. Even previously failed development projects can flag viable land.

Advertised and Vacant Parcels

Perhaps the easiest way to find land is to drive around the target area and look for signs on vacant parcels. As you drive around the market area looking for signs, also identify parcels that are vacant. This land may not be advertised for sale but, if it is in an attractive location, talk to the owner anyway. The long and short of this type of property search is simple: Open your eyes— it's all around you!

Real Estate Brokers.

Real estate brokers who specialize in raw land sales can be a good resource finding available property. One disadvantage is that sellers' brokers have a fiduciary responsibility to the seller to achieve the highest price for the property. They will often show the property to as many buyers as possible and you may find your self in a bidding situation against many other potential buyers. Brokers have been guilty on occasion of setting the sellers expectations of value at very high value. These conditions make it difficult to find property at an affordable price. We have had more success by hiring a broker to represent us as a buyer (buyer's broker). We then agree to pay the commission for any properties he or she locates for us that we buy. He then has a fiduciary responsibility to us rather than the seller and he knows he has a ready buyer that will always pay a commission in accordance with our agreement.

Government

An often-overlooked resource for finding land is your local village, town, city, or officials county government officials. They usually have a master plan and know which properties are ripe for development. The will often know the entire history of a property, potential pitfalls any what might be successful. Cultivate these relationships so they can alert you to possibilities. Additionally, in an effort to revitalize downtown areas and provide affordable housing, municipalities often look for builders and developers to partner with on difficult pieces. Partnerships with governmental entities can offer real opportunities, such as lower development cost due to existing infrastructure and tax incentives.

Personal and Professional Network.

The best resource for finding land has always been and will always be your personal and professional network. The most important strategy you can follow to locate land is to develop a network. Let everyone you know that you are a buyer of land looking for opportunities; other builders, friends, family attorneys, accountants, engineers, land planners, consultant, city staff and officials. You want anyone who knows of land for sale to think of you first. Also get the word out to the banking community that you are looking for land. In many cases, they have information on properties and development opportunities that is not public knowledge. You will find many of your best development opportunities through this network. Not only may you get to look at the property opportunity early and have a competitive advantage, but many times you will be in a position that you have an opportunity to make a deal regarding the land before there is other competition bidding on the land.

Failed Projects.

Sometimes a failed subdivision can offer a great opportunity. Often, the bank that holds the development or acquisition loan will welcome you with open arms. Of course, always do your own due diligence when determining the possibility of resurrecting a failed project. Be sure to carefully investigate the reasons for the failure. If the past failure was simply a matter of bad timing, wrong product, or poor execution, you are more likely to be successful with straightening out those problems and reaping the rewards.

Brownfields.

Brownfields are properties that, although they are not classified as contaminated sites according to the Environmental Protection Agency (EPA), have some environmental issues that may make them difficult to develop. While they are not ideal property for the first time developer, brownfields can offer highly successful infill land development opportunities. Land development on brownfields requires a letter of clearance from the state's EPA along with the additional effort and costs associated with site clean up. However, this land is often less expensive and the state, in the interest of encouraging clean up, may offer tax breaks and funding.

PRELIMINARY PARCEL INVESTIGATION

Once you have decided to create a new development in the market, your next step is to identify a parcel to acquire through a systematic investigation of each parcel. The purpose of the investigation is to make yourself knowledgeable about a particular land parcel in order to make informed decisions about whether to proceed and for what price and terms. Similar to a formal due diligence performed later in the land acquisition process, you should explore three major areas:

Physical Feasibility.

This requires that you evaluate several physical characteristics and issues, including wetlands/flood plains, vegatation, soil conditions, topography, utilities, water, wastewater disposal, surrounding uses, environmental issues, easements and right of way, and recapture obligations.

Political Feasibility.

This requires consideration of the governmental process for obtaining approval and assessing community support for your project.

Financial Feasibility.

This requires an analysis of development costs for the planned development against the land value.

In the initial phase of investigation, you complete a study to evaluate development feasibility on the parcel prior to making any expenditure. You complete this study within a short amount of time to gain initial indications regarding whether or not a parcel will support your project. Assuming the parcel investigation reaps positive indicators, it prompts you to enter into a formal agreement to tie up the land until a more thorough due diligence effort can be completed.

PHYSICAL FEASIBILITY

Continuing the preliminary investigation, evaluate the land thoroughly to determine whether it is suitable for your project. All land offers both opportunities and constraints. You must determine if the opportunities outweigh the limitations. A qualified land planner or engineer can help you complete this task.

Wetlands/Flood Plains If wetlands exist, hire a wetlands expert—someone with successful experience in wetlands mitigation. Wetland studies can be costly and time consuming if permits are required. Thus, having the right professional with experience in this area is critical. A website that may offer a thumbnail view of flood hazard areas is http://www.esri.com/hazards/makemap.html.

Vegetation and endangered species. Vegetation on a proposed site presents several considerations. First, vegetation has an impact on the property's market value. Buyer preferences for the amount and type of vegetation on a home site vary from region to region. Second, take into account the construction costs associated with parcel vegetation. If it has dense forestation, then the site improvements could be more costly. Third, consider the presence of rare or endangered plant species on the parcel.

Soil Conditions. Gaining knowledge of the type of soil a parcel presents is a critical, initial concern. The two most problematic soils for land development are expansive clays and rock. Excavation in these conditions can be somewhat costly, if not impossible,

especially if the development of the land involves road building or contouring of the earth. The presence of sub-surface rock formations can also impede utility line installation. In these and other ways, soil conditions affect the cost of the project, which, in turn, impact the actual value of the property and your determination of a fair purchase price. It is impossible to know exactly what lies beneath the surface of the ground without soil borings, however, it is possible to form intelligent guesses. Local municipality or county agencies or maps can provide a general view of the types of soils located within a geographic region.

Topography Topography. can render portions of the land impossible or impractical to develop. Generally speaking, sites with varying topography are more costly to develop than flat parcels. Most counties and municipalities have gradient restrictions for roadways, which translate to costs for required cuts and fills and careful planning to control storm water run-off through sound engineering practices. Even if zoning would permit higher density, topography may dictate unprofitable lot yields. Reviewing USGS maps provides a cursory view of topographical issues. Discussing these with a civil engineer or land planner can help you identify related problems and provide you some notion of impact and cost to your project.

Utilities. Determine the availability of electrical, natural gas, and telephone service on the parcel as a part of your preliminary investigation. These services are generally available in most areas but several circumstances can increase the complexity of establishing these utilities. For example, the transmission lines to a parcel may not have the capacity to service additional users.

Water Developing a new subdivision and then encountering water source problems can be catastrophic, even if all of the lots have been sold. Experts predict that the greatest issue for tomorrow's land developer will be water availability—an inadequate water supply limits development. There are several factors that affect the availability, including source and line capacity, well water availability, and source contamination. Just because there is water available at the property does not necessarily mean there is water available for a new development. Water sources or the existing distribution lines may not have the capacity to handle new development within the parcel of land. Local water utility service companies and health departments can provide information on these and any other water supply issues.

Wastewater Disposal For any parcel, it is important to consider the method for wastewater disposal to evaluate project feasibility. In many situations, the location often determines what type of disposal system can be constructed. There are three primary means of providing for the disposal of wastewater:

- Public wastewater disposal
- Individual site systems
- Community systems

Public wastewater disposal is rarely available in areas surrounding municipalities that offer land development opportunities. Generally, you are required to install new lines and

to provide any service extension lines without costs to the public utility service provider. Even if this infrastructure exists through underground lines, the capacity for new development may be limited.

Surrounding Uses. Your preliminary investigation should consider how the land surrounding the parcel is being used. Make sure that the proposed use of the parcel will be compatible with the current and planned uses of land in immediate proximity. Common sense should guide your conclusions regarding how surrounding land uses support or detract from your anticipated use of this land. Consider these examples:

- What-impact would a waste management facility next door have on a single-family subdivision?

- How will the surrounding neighborhoods react to the two and three-acre lots perceive the one-fifth acre lot development you plan for this parcel?

- How will commercial uses of the surrounding land impact the property value of your planned residential development?

Certainly these scenarios present extremes but they illustrate how important it can be to consider surrounding uses and their impact on your project.

Environmental Prior to actual purchase of the property, most lenders require an environmental study as specified by the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) and the Superfund Amendments and Reauthorization Act of 1986 (SARA) . (These laws are also referred to as the Superfund statutes.) These environmental studies, which focus on site inspection and cleanup requirements for hazardous waste, take a lot of time and money. You can gather valuable information from physically walking and examining the land and determine if there are any potential “clean-ups" that maybe necessitated under the Superfund Act and would generate additional cost for the development project. Just as in the formal studies, look for signs of potential problems on the land. Some potential clues include, current or previous uses that involve manufacturing assembly, repair, laboratories, storage, shop services, clearing, or other related businesses

Easements and Rights of Way. The presence of utility easements, future road access easements, and road rights of way can have an impact on development based how they impact homeowner safety, site access, development restrictions, and future surrounding growth.

Recapture Obligations and Impact Fees. While the price of a parcel may seem like a deal, existing recapture obligations can significantly raise your cost of development. In some cases, municipalities may have provided or required developers to complete infrastructure or improvements on the parcel to support future development. These improvements are typically made with plans to recover the related costs through future

developers on a pro-rata formula. When considering a tract of land for purchase and development, determine if any recapture obligations exist.

Municipal governments have also taken to charging impact fees for land development. They are justified as financial compensation for the added burden of upgrading water and sewer treatment facilities, upgrading schools, and other impacts of new development. Some local governments have created "Adequate Public Facilities Ordinances" as a means to slow down growth or to collect additional money from the developer.

POLITICAL ANALYSIS

As part of the political analysis, explore factors that can have an impact on your planned development. These factors are the political climate, applicable zoning, approval process, and community support.

Applicable Zoning

Examine master land use ordinances to determine the municipality's vision for future development. For example, if a parcel in the targeted area of town is currently zoned as a rural buffer zone, but master land ordinances classify future development as mixed used in nature, your proposed development for 40 town homes will likely find favor with local officials. Conversely, plans that are not consistent with municipal zoning may necessitate zoning changes to proceed. These zoning changes can require extensive effort and complex processes that can impact your development costs.

Approval Process

Eventually, you'll need to obtain approval of your site plans and improvements. Talking with local officials prior to submitting your plans can give you a general understanding of the approval process and the related level of effort it may require.

Community Support

Public concerns and protests can squelch a new development. Thus, your political analysis should explore the level of community support for your project. Give some thought to the anticipated reaction of the community to the proposed development. These groups often times represent a small percentage of the population, but can be extremely vocal at public hearings for development approval. The key is to identify the active groups and what concerns may be raised with your particular development. Talk with other developers or the municipal administrators. They should be able to give you insight about groups that may surface opposition to your development.

FINANCIAL ANALYSIS

The cost of a parcel is a key factor in the development of raw land. In the preliminary investigation you determine the value of the parcel through a financial analysis. Your analysis begins with considering the revenue potential and then overlaying cost to estimate affordable land pricing.

For example, consider this scenario. Best Deal Developer has determined through market research that a need exists for an in-fill subdivision for single-family homes with an average selling price of $250,000. Best Deal determines that:

- The ideal lot size should be approximately 1/4 acre.

- A subdivision of approximately 40 lots would offer the best absorption in the market. Therefore, it requires a site that is approximately 12 to 15 acres allowing for recreational space and other rights of way.

Best Deal locates a 15-acre site and must determine a fair market value of the property or the price range in which they can reasonably negotiate. The following worksheet illustrates the lot analysis.

LOT ANALYSIS			
Description	**Percentage**	**Best Case Per Lot**	**Worst Case Per Lot**
Lot Sale Price	100%	$ 50,000	$ 50,000
Profit Margin	30%	$ 15,000	$ 15,000
Indirect Soft Costs	6%	$ 3,000	$ 3,000
Marketing Costs	4%	$ 2,000	$ 2,000
Infrastructure Costs	40%-45%	$ 20,000	$ 22,500
Land Price/Unit	15% - 20%	$ 10,000	$ 7,500
Total Price		$400,000	$300,000
Price Per Acre		$ 26,666	$ 20,000

Best Deal's analysis begins with the lot sale price. This is the total of several costs: profit margin, indirect soft costs, marketing infrastructure and land price per unit costs.

Profit Margin. The profit margin is based on both business preference and related risk. Risk is based on the projected amount of time required to complete the development and sell or build on all of the lots, as well as the level of guarantee of selling the product, (e.g., whether or not you have builders under contract to buy lots). Profit margins may be reduced if risk is reduced; they may also be raised if the risk is higher. For example, developers who plan to improve and sell land to a third party for development typically seek a 25 to 33 percent margin of profit. Compare this to the 15 to 22 percent rule of thumb for developers/builders. They assume less risk and can expect additional profit from the home price so their expectations for profit are lower. Best Deal Management, as a "developer for sale" determined a desired profit margin of 30 percent.

Indirect Soft Costs. These are costs associated with things such as indirect or finance costs, legal fees, and other general administrative costs. Best Deal estimated they would be approximately 6 percent of the lot sales price or $3,000.

Marketing Costs. These are costs associated with commissions and other related selling expenses. Best Deal calculated these at 4 percent of the lot sales price or $2,000.

Infrastructure Costs. Infrastructure improvements are specific to the geographical area.

Best Deal discussed per lot or per unit costs with local engineers and land planners. These professionals provide valuable information based on their historical experience in the area. They also offer pertinent information on lot yield and costs based on topographical concerns. Best Deal arrived at $20,000 to $22,500 per lot or 40 to 45 percent of the lot sale price for infrastructure costs.

Land Price Per Unit**.** Also called "residual land value," this is determined by subtracting the profit and overhead, indirect soft costs, marketing costs, and infrastructure costs from the purchase price. The remainder is the amount that available to pay per lot for the raw land cost. Best Deal determines that they spend between $7,500 and $10,000 per lot for the raw land cost. Given 40 lots for the improved land this will equate to between $300,000.00 to $400,000.00 for this particular tract of land.

Total Price. The total price reflects the fair market value for the parcel. As shown in the worksheet, Best Deal established a range between $300,000 and $400,000 for the fair market value of the property. (This may seem like a wide range but it does give parameters from which to negotiate.) In this scenario if the owner has given a firm price of $800,000 chances are the deal cannot be negotiated. However, if the landowner's price were $250,000, then Best Deal might still proceed with the purchase. Keep in mind that the financial analysis does not drive the final, determined value of the property. All of the concerns of the preliminary investigation contribute to the property valuation.

Other rules of thumb can be applied to test the property valuation. Commonly:

- Unimproved, platted lots, or what are called "blanks," are considered affordable at 8 to 10 percent of the planned retail home price.

- An improved, single-family home lot cost should cost about 22 to 25 percent of the projected retail home price.

- Town home builders target an improved lot cost to home price relationship of 18 to 22 percent.

(For all ranges, production builders target the low end; custom builders aim for the higher end.)

The preliminary investigation of the parcel covers a lot of ground. (No pun intended!) It is worth it to invest this time upfront to identify any potential problems or obstacles with the parcel that would render it inappropriate for your proposed development.