

SURVIVE AND THRIVE :

MARKET STRATEGIES

Maximizing Land Residual Value Through Property Rehabilitation

A 12-step program for boosting a property's residual value

By Scot Oldham

Rather than wait around in denial, developers, investors and financial institutions that find themselves stuck with excess land in today's real estate market should focus on one thing: Admit there is a problem and take action to solve it.

For real-estate development projects, the key is discovering and unlocking the Land Residual Value. No matter what type of project it is, the basic techniques and considerations for estimating optimal LRV are the same:

Factor "A" is what the land would be worth if developed to its highest and best use.

Factor "B" is how much it would cost to develop it that way.

LRV equals "A" minus "B". The issue is how to tweak the plan either to make factor "A" larger or factor "B" smaller in order to increase the LRV.

Developers Research, a consulting firm that analyzes the financial feasibility of real estate projects nationwide, has identified 12 steps that help land developers and owners take advantage of the sophisticated new tools that are now available to help maximize LRV.

Step 1: Accept that the land is not

worth as much as you would like it to be worth.

The buyer and the seller effectively split the LRV pot to arrive at a purchase price. Negotiation is simply about how large or small a piece of that pot goes to the buyer or seller. However, with real estate sales prices down and market absorption slow, the pot will be smaller. Therefore, landowners will have to accept smaller LRV's that dictate lower prices and perhaps even selling at a loss.

Prices fluctuate with raw material prices and trade costs. In today's slow construction industry, prices are starting to drop. Projects need a detailed budget estimate, which should be reviewed monthly and updated when new information is available.

2. Choose the best plan after evaluating several alternatives.

There may be an existing plan for developing property and it might be a good one, but is it really the highest? How many alternatives have been considered? Compare the LRV of several alternatives - such as commercial, retail or residential - in order to gain a broader understanding of the value of

a piece of property.

3. Control costs by identifying the issues early.

If costs can be identified early, accurately and in detail, they can be cut to increase LRV, saving millions in costs and months of time. For example, without a comprehensive grading cost estimate, many details such as remedial grading are overlooked. Land values also can be drastically improved by controlling utility capacities, street plans, and storm drain requirements.

4. Keep your cost estimates accurate and up-to-date.

As a plan changes over time, the cost estimates need to change. Equally important, and difficult, is obtaining up-to-date and accurate cost estimates. Prices fluctuate with raw material prices and trade costs. In today's slow construction industry, prices are starting to drop. Projects need a detailed budget estimate, which should be reviewed monthly and updated when new information is available.

5. Optimize your LRV using both revenue and cost.

The two factors that determine LRV are cost and revenue. For maximum land value, consider changes resulting from both factors. Market reports may suggest a product mix, but they do not address costs. A given product type can create the most revenue, but add building costs. If costs are factored into the product mix decision, the land will

Fast Facts



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- The two factors that determine LRV are cost and revenue.

- If costs can be identified early, accurately and in detail, they can be cut to increase LRV.

reach a more optimal value. That means more profit.

6. Identify requirement thresholds that add significant costs.

Take a detailed look at project features that may be triggering costly local planning requirements. For example, how many students does it take before a new school is required? In some cases, a slight reduction in unit count can reduce the total number of students, saving millions of dollars in school construction costs. There are also techniques to reduce car-trip counts to save the project substantial offsite road requirements.

7. Maximize additional revenue through planning.

Premiums are a great source of revenue. If a commercial site is close to a hospital, consider building medical offices, which command large rent premiums. For a residential site with hills, maximize view premiums by single loading streets (building houses on only one side) as much as possible. This might result in fewer units, but it will have less cost, more revenue, and a higher LRV.

8. Forget using Internal Rate of Returns as a measure of success for land development.

Internal Rate of Return (IRR) is great for some types of financial estimating. Land development is just not one of them. The problem with using IRR as a land development metric is the amount of variability inherent in the development process, most notably time delays and the unpredictable cash flows that result.

9. Be as creative and flexible as possible when structuring your land deal.

Instead of closing immediately, create a longer-term escrow allowing for the close of escrow to occur up to 90 days after approval of a subdivision map. This relieves some of the entitlement risk inherent in land development. The seller could then also participate in any price increases based upon a "to be determined" formula. Joint ventures also allow the buyer and seller to spread the risk while benefiting both sides. Using creative deal structures can help a borderline deal become a success.

There is a wide range of opportunities available to developers to fund projects. Explore making concessions on development features as a way of negotiating fee reimbursements.

10. Use every possible funding avenue.

There is a wide range of opportunities available to developers to fund projects. Explore making concessions on development features as a way of negotiating fee reimbursements. In predominantly residential projects, create Community Facilities Districts (CFD) to fund regional improvements. Use Tax Increment Financing (TIF) to share in the profits from future commercial revenues. There are many new government grants encouraging sustainability, energy efficiency, and green building. Use them.

11. Ensure that your entitlements last through a downturn.

The real estate market is cyclical. There has been a semi-regular pattern of ups and

downs for years. Make sure entitlements last through the downturn. Negotiate longer terms with a development agreement. Create Vested Tentative Tract Maps (VTTM) instead of conventional Tentative Tract Maps, allowing a longer time between when a map is approved and when a project is built.

12. Manage your downside.

Prepare an exit strategy. Keep it updated. Use it. If encountering entitlement problems, be prepared to sell the property to a third party who has a better opportunity to obtain approval because of local connections. The original borrower might sell at a loss, but it is better to lose some of the money than all of it.



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• An existing development plan should always come with considered alternatives.

• Building fewer units often means less cost, more revenue, and a higher LRV.

• A longer-term escrow relieves some of the entitlement risk inherent in land development.

• There are many new government grants encouraging sustainability, energy efficiency, and green building.

• A prepared exit strategy is crucial for any development project.