

# Lock Up Development Financing

Help lenders feel confident about a project's profitability, costs and exit strategies

By **Martin Kulli**, project director, Developers Research

**T**HE DOWNTURN IN THE REAL estate market and the fallout from the nonprime mess have upended the development world. Builders and developers are facing tough issues, including financial losses, foreclosures and layoffs. This turmoil is also creating problems for commercial mortgage brokers — those who are experienced as well as those who are just getting into the commercial-funding game.

Because of these changes, positioning real estate development projects to ensure they lock up needed financing is of paramount importance to a successful brokerage. To secure financing, it helps to view the current real estate climate through a lender's eyes. Lenders want to feel confident about a property's profitability and costs, as well as about the borrowers' ability to avoid financial problems.

By keeping these issues in mind, brokers can prepare deals that address and alleviate lenders' concerns.

## Ensuring profitability

For real estate development projects, the size of a loan depends primarily on the expected land residual value (LRV). LRV is the difference between projected revenues and projected costs. Lenders use a percentage of this value to determine how much they are willing to lend.

Loan-to-value (LTV) ratios are trending down for all types of loans. Gone are the days of 70-percent- to 80-percent-LTV construction and development loans. Today's more-conservative LTVs range from 40 percent to 70 percent. This reduces the proceeds from the loan and increases the cash required from borrowers.

Brokers can help their clients offset the

reduction in LTV by helping them increase the LRV. There are several methods brokers can suggest to their borrowers that could increase their projects' values:

■ **Consider other development plans:** Too often, land developers are fixated on an existing building plan. There may be reasonable alternatives, however, and brokers can encourage their clients to examine other options. This can allow for more-informed and well-reasoned development decisions.

■ **Maximize profits through planning:** Efficient planning can boost revenue with little or no increase in costs. If a commercial site is close to a hospital, for instance, developers should consider building medical offices that command large rent premiums. Or for a hillside residential site, single-loaded streets can reduce costs and generate view premiums.

■ **Make changes in cost and revenue:** Market reports help determine the product mix by offering pricing and sales projections, but they don't address costs. Therefore, they can provide an incomplete picture. Developers should look beyond market reports and balance decisions against potential cost and revenue to add to the bottom line. If they can maximize revenues while minimizing costs, the project may become more profitable and easier for a lender to approve.

## Managing costs

An insatiable market and the availability of cheap money during the past few years meant that many lenders were loaning money somewhat blindly. But they have realized their previous mistakes and are now more apprehensive about financial projections presented by borrowers.

Brokers can ease these fears by encouraging borrowers to contract qualified, outside consultants to prepare independent cost evaluations. This displays a willingness to open proj-

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ects to outside scrutiny and criticism, while allowing borrowers to address any issues before approaching lenders.

There are several other things that brokers can suggest to borrowers to stay on top of costs:

■ **Identify issues early:** Overlooked costs at a project's inception can create expensive overruns and lead to construction delays, which seriously hurt project finances. There are tools, however, that can identify future costs.

For example, with a digital grading analysis, the amount of dirt that needs to be moved for a project can be measured accurately ahead of time to help avoid the expensive costs of importing or exporting dirt. Developers can identify and control other major costs early on including utility capacities, street plans and storm-drain requirements.

■ **Determine requirement thresholds:** By keeping the size of a project in check, brokers can help their clients cut costs. For example, reducing project density can negate the need for construction of a larger road or extra parking. Changes in the development plan can save substantial offsite costs or reduce the need for expensive municipal requirements such as additional parks.

■ **Keep the cost estimate accurate and current:** Changes in the plan also change the costs,



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## Development Financing

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and that should be reflected in the budget. Prices of raw materials and labor fluctuate and can fall in a declining market. Update budgets monthly or quarterly.

### Mitigating financial problems

Unfortunately, even with diligent preparation, developers sometimes encounter problems. Lenders consider the likelihood of these issues when they evaluate loans.

There are a number of options, however, that brokers can use to steer developers' projects away from risk:

- **Use creative escrow:** Developers can enter a longer-term escrow, allowing for the close of escrow to occur 35 days after approval of a subdivision map. This approach might complicate the sales process, but it should decrease entitlement risk.

- **Seek various funding avenues:** Because smaller loans are easier to get, brokers should look for ways to decrease funding needs by using public-finance tools. Developers can apply for government grants that encourage sustainability, energy efficiency and green building to lower construction costs. Other options include talking with city planners about incentives for floor areas, building heights and parking requirements.

- **Manage the downside:** Developers should prepare an exit strategy and keep it updated. If they encounter entitlement problems, they must be prepared to sell the property to a third party with local connections and better chances of obtaining approval. The original borrower might sell at a loss, but it is better to lose some money than all of it.

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To ease the challenge of obtaining financing, brokers must help developer clients address the issues that concern lenders most: whether a property will be profitable, what it will cost and how borrowers will deal with financial problems. Recognizing and addressing these issues will inspire lender confidence and can lead to an easier underwriting process. **!**