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12 Things You Should Know Before You Sell

By BARRY GROSS AND SCOT OLDHAM

The outlook may seem grim for California banks, investors and real estate lenders who have foreclosed on land holdings or incomplete projects for commercial, mixed-use or residential developments hard hit by the declining real estate market and resulting credit crunch. But reluctant land owners may be able to recover much or all of their investment by looking at their newly acquired property in a different light.

Developers and builders across the state are increasingly unable or unwilling to make payments on idle land or incomplete projects they purchased with loans during the real estate boom. If they can't recapitalize, many financial institutions will opt to foreclose on land or unfinished projects. Unfortunately, these new land owners may have little experience in real estate or lack the time and resources to evaluate each project and may opt to sell at a loss when there are other alternatives.

Financial institutions and investors looking to unload or complete unfinished development projects need quick answers to some complex questions:

Should we sell this property or hold on to it until the market comes back?

What is my property or uncompleted project worth now?

Did the previous developer accurately estimate the cost to completion?

Is the current site plan the best use for this property?

What should we do now?

For real estate development projects, the key determinant of whether it is worth the time and effort involved is the expected land residual value. Whether it is a prime piece of real estate right in the path of development or an urban-infill site that could stir controversy, the basic techniques and considerations for estimating optimal land residual value are the same. What would this land be worth if developed to its highest and best use? How much would it cost to develop it that way? The difference is the land residual value. Now the issue is how to increase the land residual value by tweaking the plan or cutting back on costs.

As any developer knows, this isn't as easy as it sounds. However, there are at least 12 factors to consider that will help new land owners both establish and optimize the value of unwanted property, especially in a declining market.

1. Realize that your land is not worth as much as you would like it to be. By taking the projected revenues and subtracting projected costs, the land residual value can be estimated. The land residual value then effectively is split between the buyer and seller.

2. Choose the best plan after evaluating several alternatives. The existing site plan may not be the best plan. There may be alternatives, such as higher density, more commercial product or a different mix than envisioned, that enable you to make a more informed and reasoned decision about the value of your property.

3. Control costs by identifying the issues early. Overlooked costs at the project's inception create expensive overruns and leads to delays to build-out. For example, grading often is the single largest development cost for a project and can run into the millions of dollars. Your land residual value also can be improved dramatically by controlling other major costs, such as utility capacities, street plans and storm-drain requirements.

4. Keep your cost estimate accurate and up to date. Changes in the plan also change the costs. Prices of raw materials and labor fluctuate and can fall in a declining market. Budgets should be updated monthly or quarterly.

5. Optimize your land residual value using both revenue and cost. Since land residual value is determined by cost and revenue, to optimize for the maximum land residual value you must consider changes in both. A market report will point the way to the best product mix and offer sales projections. But because market reports don't address costs, they provide an incomplete picture. One product type may create the most revenue but its higher building costs will reduce land residual value.

6. Identify requirement thresholds that add significant costs. For example, reducing project density or providing alternative transportation methods will result in fewer car trips that will negate the need for construction of a larger road. Changes in your development plan can save substantial offsite requirement costs and maximize your land residual value.

7. Maximize additional revenue through planning. If you have a commercial site that's close to a hospital, consider building medical offices which command large rent premiums with little comparative increases in costs. For a hillside residential site, single-loaded streets will reduce costs and generate the potential for view premiums.

8. Forget using internal rate of return as a measure of success for land development. IRR may be great for some types of financial estimating but land development is not one of them.

9. Be as creative and flexible as possible when structuring your land deal. Land residual value projections in today's market are grim. A little creativity can yield solutions that benefit buyers and sellers with little negotiation and can help a borderline deal succeed.

10. Use every possible funding avenue. Creating community facilities districts and using tax increment financing can help along with government grants encouraging sustainability, energy efficiency and green building. Talk with city planners about incentives for floor areas, building heights and parking requirements. Negotiate fee reimbursements from regulatory agencies.

11. Ensure your entitlements through a downturn. Negotiate longer terms with a developer's agreement. Create vested tentative tract maps instead of conventional tentative tract maps. They allow more time between when a map is approved and a project is built.

12. Manage your downside. Prepare an exit strategy. Keep it updated.

These are not just tips for a down market. You should be practicing these techniques with real estate all the time. It seems when times are good, fundamentals are overlooked. Things move fast during a booming market. Revenue inflation covers up planning inefficiencies, effectively throwing value away. When the good times return, which they will, we should continue using the skills and practices that carried us through the rough periods.

Barry Gross, left, is president and **Scot Oldham** is senior vice president at Developers Research, a national real estate consulting firm based in Southern California.