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The Riddle Report

Development And Financing Of Raw Land

When an investor purchases land to build on, the next step is land development and financing. “Land development” cannot be precisely defined; generally, it refers to the physical, legal, and engineering processes needed to convert raw land to land (or lots) on which buildings can be placed.

Land development can be classified into the following six stages:

- **Annexation.** Taking the necessary steps to have land included within the boundaries of a municipality so that it can be eligible for municipal services.
- **Zoning.** Taking the necessary steps to obtain a zoning classification that permits the proposed use of the land.
- **Surveying.** Preparing an accurate and detailed survey of the land, showing not only the boundaries but also grades, drainage, topography, and other features of the land.
- **Land planning.** Drawing up a plan for the use of the land that is consistent with its physical characteristics, applicable zoning and land use regulations, and projected demand for types of land use.
- **Subdividing.** Platting (mapping) the land into blocks and lots in compliance with local laws and subdivision control ordinances.
- **Physical improvements.** Changing or improving the land by grading; landscaping; installation of streets, sidewalks, and sewer, water, electric, and other utility lines, drainage and retention basins, and similar physical improvements.

Loans for land development are usually obtained from the same institutional sources that provide land acquisition loans. One important source of financing for land loans, the seller that takes back a purchase money mortgage or sells on an installment basis, is unavailable for development loans because these require the provision of actual cash rather than merely the extension of credit on the sale of the land. Thus, if institutional financing for land development is not available, the developer must seek other non-institutional sources. One possible source is a syndicate of private investors that puts up capital either in the form of equity or a participating mortgage. Another source is a loan from a real estate investment trust or pension fund, which sees land development financing as a way of providing above-average returns from real estate investments. ❑

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Considerations In Ground Leasing

Landowners may choose the ground lease as a way to benefit an easy and risk-free investment vehicle and as a way to secure the long-term appreciation of the property. Sometimes a ground lease can put the lessor at risk. That is because the deal centers on the concept of sharing economic returns. The lessor becomes a partner of the lessee because the total rent is usually determined by the lessee's net operating income or net cash flow. If the lessee does well, the lessor does too. However, if the lessee's business is a loser, so is the lessor.

Therefore, the lessor must consider the financial feasibility of the project. Independent analysis should show that the project represents the correct improvement of the site and that the projected payments will actually be received by the lessor.

There are at least four things that a prospective land lessor should remember before entering into a transaction:

- In most land lease transactions, the economic return to the lessor ultimately reflects the underlying performance of the real estate operated by the lessee.
- The lessor's evaluation of the deal must focus on the quantity of income projected pro forma but also must include a clear assessment of the likelihood of actual receipt of projected rent.
- Because the conditions and complexities of a land lease can mask the risk associated with achieving the projected rent levels, accurate assessments of the strengths and weaknesses of the real estate is essential.
- Land lease provisions must be tested against the current fee value of the land. ❏

Increase Income By Upgrading

One of the ways to increase income and value is to upgrade an older property. In every community, anyone who looks can usually find a number of commercial buildings, apartments or offices that need to be modernized. Some are for sale because the present owner may not recognize the increased return that they could get or do not want to make a further investment. The property might be purchased at a bargain price that is based on the current cash return.

Don't overlook properties that are still productive, but may have a much greater potential after a conversion. Factories have been converted to shopping centers all over the country. Old Movie theaters have been converted to multi-screen facilities. Garages have been converted to condominium parking buildings. Seeing potential profits in older buildings takes imagination.

When you set out to upgrade an older building, you will encounter three kinds of deterioration or obsolescence: *physical deterioration, functional obsolescence, or economic obsolescence*.

The first of these, *physical deterioration,* starts immediately after the building is completed and continues throughout its entire life, unless it is handled along the way with proper maintenance and repair. This type of deterioration usually can be taken care of by routine repairs and replacement of parts. Anytime the acquisition of a run-down building is being considered, the investor must be certain that the deterioration has not become so bad that the building will have to be demolished.

Functional obsolescence happens when the property loses its usefulness as a result of changes in styles or in the needs of tenants. As an example, an older apartment property could have an electrical system that is inadequate to handle modern appliances such as air conditioning, microwave ovens, computers, television or other recently developed equipment. This type of obsolescence can be cured usually by installing updated equipment.

Economic obsolescence is a change in value that is caused by circumstances that are not directly related to the property. Often this is a change in the neighborhood, such as a change in the use from residential to commercial or industrial. When this has happened, modernization of the building may not be worthwhile. If the building is structurally sound, it could be a good prospect for conversion.

Five Ways To Upgrade

There are five ways usually used to modernize a building. These are: (1) structural changes; (2) architectural changes; (3) functional changes; (4) mechanical replacements; and (5) aesthetic improvements.

When a building is quite old, structural changes may be needed for safety reasons. Before you purchase the building, a professional engineer

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(continued)

should make an inspection. This can determine whether the building is structurally sound and what changes, if any, will have to be made.

The building can be partially redesigned with architectural changes during the modernization. If a building has very distinctive architectural features rather than a plain exterior, some investors feel that the property has a greater investment potential.

Functional changes and mechanical replacements can reduce costs in an old building and increase efficiency. Wiring will usually need to be replaced to provide safety for modern electrical and computer equipment. Old heating systems will usually be inefficient and cause high maintenance costs, and should be replaced. An example of a mechanical replacement would be a change from an old, slow elevator to a modern one.

Aesthetic improvements are the sprucing up of the property and can usually be done at a relatively little cost. When an investor is looking for a quick resale, this type of improvement may be done rather than some of the others. Cleaning up the property, inside and outside, installing new lighting and repainting the building can be enough sometimes to make a quick, small profit.

Why Do The Upgrade?

When an investor is looking for the proper investment, older apartment buildings in good neighborhoods often look better for a long-term commitment than new construction. When a property is modernized, rents can be raised substantially and, if the work can be done without disturbing the existing tenants, the investor will not have the expense of carrying the property as he would in new construction. He would also hope that most of the existing tenants would stay and pay the increased rents, so the costs related to acquiring new tenants, as would be needed with a new construction, would be avoided.

Finally, the overall costs may be less. Although the price of the property may be high in relation to the current rents, the final cost after modernization may be far less than the cost of new construction. With this lower cost, the investor may be able to charge lower rents than new buildings nearby, putting him into a very competitive position.

Conversion To A New Use

Unproductive properties can present opportunities for big profits. When a building is bringing in little or no income because obsolescence or because of changes in the neighborhood that have made the location unsuitable for the original use of the building, converting to a new use can make a new profitable income stream. As an example, a movie theater in an area converted to industrial might be changed to a factory or warehouse. Some neighborhoods have changed from warehousing and factory areas to residential. A factory building that is no longer being used could be converted to a residential condominium project or a shopping mall. ❏

A Comfort Zone in Loans and Investments

Each investor has a "comfort zone" about loans. The leverage seeker wants the largest loan that is practical. Others may have experience or training that calls for no loans at all. They must have the property free and clear.

Most of us have a loan comfort zone somewhere between these extremes. Nearly everyone accepts the idea of some sort of mortgage. The use of OPM (other people's money) makes sense.

The comfort in loans may affect the type of investment. Many of these "free and clear" owners prefer land as the investment. They want no improvements on it, just the bare land.

Here's some of the benefits of investing in unimproved land. These can make a lot of sense:

1. **There are no tenant problems.** There may be a simple lease for farming or grazing, but only limited contacts between lessor and lessee. Often, the investment land lies unused.

2. **A well-chosen land investment can result in huge profits**. We have all heard stories of owners who have purchased land for just a few dollars an acre, then later sold for millions! (The key is "well-chosen.")

3. **Land is a secure investment.** Even in the worst economic situations, the land is still there. Value can fluctuate, but the investment will not disappear.

4. **Land represents wealth.** It can be a quick source of cash for an owner to use for another investment. Land looks good on a financial statement. It adds permanence and stability to an applicant for loans or for a line of credit. ❏

Is A High Risk Troubled Property Right For You?

In any market, good or bad, there are always problem properties. Most are only troubled or problem properties because of the current ownership. Some may be neglected only because the present owner has failed to do fairly simple things that can solve the problems. Buying property and solving problems is a profit-making business.

Have you seen: An empty office building. A remodeled apartment house or hotel that has an excessively high level of vacancy. A large tract of undeveloped land that no developer has become serious about wanting to develop. These are examples of troubled property–property that is a definite financial burden to continue to hold but which also is unattractive property to some prospective buyers. Unattractive, that is, until very recently.

The timing now seems increasingly right for investors to obtain troubled property at bargain prices. The pressure on owners and lenders with troubled property to get out from under the on going burden is also high. The result is that syndicates have been formed to seek out and buy up troubled properties.

High Risks Not For Everyone

Knowledgeable property developers and managers (especially those familiar with empty or near-empty office, hotel, and apartment buildings) caution that buying troubled property requires taking a very high risk. The financial returns are uncertain and may be a long time in coming, if they come at all. This type of investment is not for everyone; it's for those who can afford high risk situations.

The profits can come from any one or a combination of circumstances.

- A market turnaround caused by a boom in the local and/or national economy.
- An improved system for promoting and operating the property. Some syndicates are being formed solely to manage the troubled property with an option to buy when and if it hits a specified profit level.
- Purchase of the property at a bargain price, often combined with imaginative and untraditional financing techniques. Some lenders are asked to share the financial risks by accepting a low initial interest rate in return for a big share of the profits later on. Sometimes the seller of the troubled property is asked to retain a financial stake in the property and to help turn it around. The seller's experience and involvement in the project from the start can be valuable.
- Including the troubled property in a larger development plan. An office building that sits empty might become part of a new industrial park with hotels, conference facilities, and residential apartments, all of which are successful.

Take another look at troubled properties in your area. With fresh new ideas and a re-structuring of the mortgages, the troubles may go away, leaving a profitable investment for you. ❏

Commercial Real Estate Representation

There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. A professional real estate practitioner must stay aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. ❏