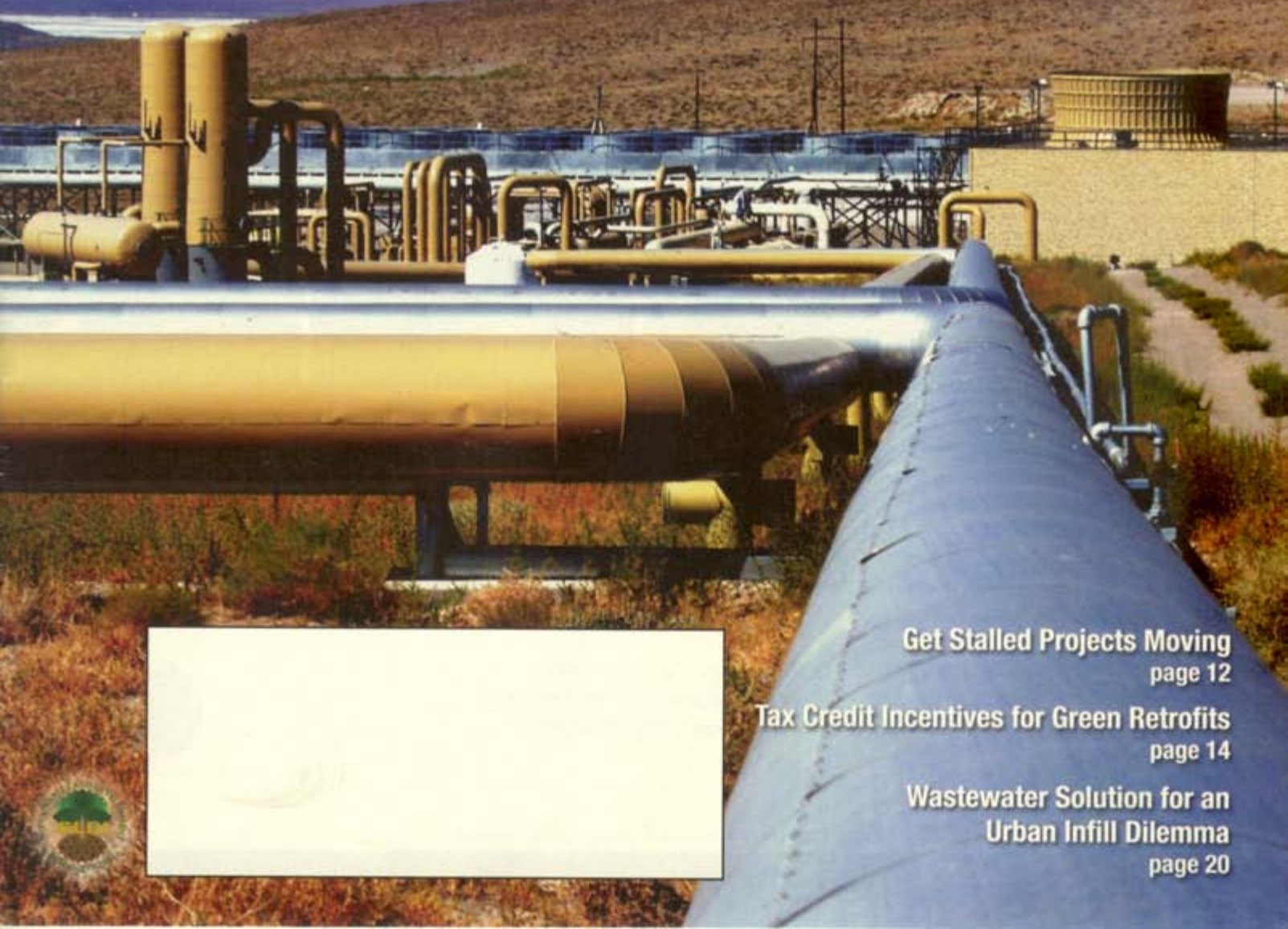


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How to Get Moving Again

New partnership with equity investors help developers thaw the freeze on interim construction financing.

By Jeff Burton

Even in the midst of today's historic credit freeze and a widespread perception that the commercial real estate market is overbuilt, there may yet be hope for experienced developers to get stalled projects jump-started again.

Before exploring a possible solution, let's look at the two key facts on the ground:

Fact 1: There is no shortage of attractive potential projects on the books of experienced commercial developers. But those projects are going nowhere because of the near impossibility of getting financing for construction.

Fact 2: There are also billions of investor dollars looking for an opportunity to go to work. Stabilized, commercial real estate – in particular, residential rental developments – would be particularly attractive to these investors. But the best of such properties are scarce in today's marketplace, because their current owners are reluctant to sell at what they perceive as depressed prices.

In short, the collapse of the credit markets has bred fear into the lending institutions and equity investors alike, especially where real estate is involved.

But overcoming these obstacles of tightened investment is possible through a fundamentally new business model for equity investors and developers. It will require creativity, flexibility and above all mutual trust.

The bottom line: Equity investors need to put their money to work. Developers need to deliver new projects to stay in business. That's right. They still need one another. Now they need to re-think the relationship to form a sensible

approach out of a situation that is currently unsustainable.

How We Got Here.

There is good reason for so much uncertainty in commercial real estate lending; property values have rarely been so volatile. Since the passage of the Uniform Act by Congress in 1970, appraisal format and procedures have been set by the federal government.

Likewise, banking regulators have reviewed loan packages based upon, among other things, the ratio of lending to appraised value. The problem is that appraised values, especially in commercial properties, often do not reflect real value, and most importantly, liquidity value. More interestingly, the developer's loan amount is restricted by some intangible quotient tied to cost, though an appraisal is still required. This is typically to constrain cost to value.

This incongruity has resulted in inflation of hard cost to cover soft cost and has in many cases resulted in loan stripping. This is primarily due to the lack of third party oversight of cost and construction progress inspections. These factors which, when left unchecked, created a relational strain between investors and developers.

Regardless of the reasoning, the reality is developers are now left with projects in which they have sunk a substantial amount of cash and/or equity. But due to massive real estate value adjustments, lenders and equity investors no longer have a reliable gauge for the developers' land values and therefore are avoiding them or requiring

unworkable valuations and/or ratios. The unavoidable result is that there is no interim financing available for construction.

The situation is unsustainable in the sense of the broader market and here is why: Recessive economic principals indicate that though a development market may be in decline, ongoing market redevelopment is still required. When cash tightens, the need for replacement properties within the commercial and residential rental sectors does not necessarily diminish. Older, unsuitable product is vacated for more efficient, newer or redeveloped properties.

So in our current economic environment, where declining properties cannot secure financing to renovate, and Class A properties are not for sale, high-quality, ready-to-develop projects can be the best opportunity both in short and long term.

The developers of these projects and their investor partners will need to take an even more transparent and integrity-driven approach to their relationship with the proposed new financing model.

The Concept

Let's illustrate how the model might work with the example of a 400-unit, multi-family residential project fully entitled and designed.

The developer currently owes \$400,000 or \$1,000 per unit. The equity investor requires a 100-unit take down in each of four phases. The agreed upon price is \$100,000 per unit. The hard costs are \$80,000 per unit. The bank provides a partial release for a \$100,000 payment,





leaving \$300,000 in residual debt. Land for 100 units is transferred to joint entity. The 100-unit phase will require six months for construction and a six-month stabilization period. Rents are estimated at \$1,200/month with expenses of \$150/month. Net monthly rents total \$1,260,000 for the 100 units.

Some presets must be established:

- Unit Land Value (minimum agreed upon value of the entitled ground)
- Development and construction cost (hard cost and soft cost)
- Tiered Stabilized Value (completed purchase price based upon anticipated rent revenues; a factor of attainable rents, cost, occupancy rates, etc). Up to 50% - recovered cost and land value 51% to 100% - 9%

A: Tiered Stabilization Valuation Schedule:

- 0-50% - \$10,000,000
- At 75% - \$10,500,000
- At 85% - \$11,800,000
- At 95% - \$13,194,000

The additional percentages would be based on predicted rent revenues and applicable CAP rate for applied occupancy levels.

B: Stabilization Period - from close of last unit in phase to full portfolio transfer to equity investor.

Initially a legal entity must be set up to hold, unencumbered, a portion of the land and improvements. Ownership is held fully by the developer. As funding is injected by the equity partner, ownership transfers proportionately to the tiered stabilization value (0 - 50%). Construction draws are transacted as they would be with a traditional lender with the release coordinated by a qualified third party. All net pre-tax from rent revenues prior to the end of stabilization period flow into a settlement account to be distributed per a performance bonus agreement. Upon completion of funding, ownership is completely transferred to the equity partner less an agreed upon retainage ownership amount held by the developer until settlement at the close of

the stabilization period. The settlement amount for retainage release will be based upon the tiered stabilization value.

If at the end of the stabilization period, the occupancy is 85 percent, the purchase price will be \$11,800,000. Total accumulated payments from the equity partner equal \$8,000,000 (100 units at \$80,000). Amount due at close is \$3,800,000. Total ROI is 10.6 percent cash on cash. As occupancy increases during stabilization, the risk premium decreases for the investor and provides greater return to the developer. Conversely, if the project is underperforming, it is sold at a predetermined cost.

The new paradigm is based on several initial conditions:

1: The developer must possess the ability to reasonably predict the construction cost on both the horizontal and vertical elements and/or have a reliable and stable engineering and building partner who can do the same. The developer is also assumed to be substantially vested in the property and have some access to additional capital. This allows for the developer to deliver product without incurring substantial leverage against the property, allowing for limited releases on constructed ground, and initially allowing for the transfer of unencumbered real property to joint entity.

2: The equity partner must first and foremost recognize that there is a shift in risk premium, in that the property and its price are not stabilized. The truth however is that all properties are at some level of instability. For instance, a stabilized property with established rent revenue has a certain CAP rate value. If a superior product enters the market for the same price, the previously stabilized project is subject to decreasing occupancy and/or rental rates. The previous example of a new project has greater control of adjusting more efficiently to the current market and becoming the hypothetical superior product.

Value Proposition

The value proposition of this structure does several things, most impor-

tantly allowing for staged takedown, based upon proofing both parties' assumptions. It also allows for a responsible developer to utilize returns from the first stage takedown to free up future phases through deleveraging for the continuance of the relationship and the completion of the project. For the equity partner it allows for a worst case (based on low occupancy) purchase scenario at true cost, and a best case scenario with a pre-arranged CAP Rate price.

There are several other advantages to this model. First, the equity partner, acting as a defacto interim financier can receive a debt service payment in the form of a preferred return from the settlement account. The rate, at a discount to current commercial rates, would be determined at the initial negotiations. An additional benefit would be the elimination of some transactional cost, like origination fees. Due to the operational nature of the project, property tax and other ongoing cost can be drawn from the settlement account, reducing the developer's cost prior to sale. Lastly, the developer bears the burden of proofing the concept through having to deliver some level of stabilization to realize any profit.

The key is that both the developer and the equity partner's motives are aligned to benefit each to a common end. There is no disincentive for efficiency, transparency or mutual profitability. This is the cornerstone of the concept's success and continuation to potential for the partnership. **SLDT**

Photos courtesy of American Dream Development photographer: Curt Cuthbertson

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