Great Developments All Begin with Great Dirt…

Don't Forget About the Dirt.

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It's been said that commercial real estate is a ground-up business. The simple truth of the matter is that at some point in time every real estate project started with a piece of land and a vision. If fact, the success of any development project will largely hinge on how astutely you can finance the land component of your transaction. The good news is that as sophisticated as the commercial capital markets have become, not a lot has changed with respect to how land is treated. In the text that follows, I'll share some basic thoughts on how to use land to drive project returns.

As I alluded to in the opening paragraph, the one clear exception to the advancement of real estate capital markets has been in the arena of land financing. Land is the one asset class that is lagging the balance of the market as far as the number and sophistication of new financing options. Furthermore, even in today's constrained market, land is the one asset class whose underwriting guidelines have remained fairly constant. Land is, by and large, financed today in the same fashion as it has been throughout recent history.

Given that in the majority of circumstances the largest impact on the profit margin in a real estate project is made based upon how well the land is acquired and financed, it seems somewhat odd that the options for financing land have not advanced at the same pace as that of the other asset classes. In order to understand why land seems to be the asset class exception when it comes to aggressive and favorable financing options, it is important to understand the two main underlying characteristics of land as an asset that taints its appeal to lenders:

1. **Timing:** By its nature, land is financed at the beginning of a project lifecycle making it the most speculative stage of project capitalization. Early stage investments (debt or equity) in any industry are the most costly to fund due to the increased risk profile. Adding to the complexity of the risk profile, land is often unentitled at the point initial funding is sought, and thereby requires some form of municipal cooperation in order for the project to be successful. Complicating matters further, is that depending on the specifics of the project, it can take several years to secure the necessary entitlements which will be needed to insure that the project is viable, and during that time there is often no assurance that said entitlements can be procured.

2. **Lack of Income:** Unlike stabilized operating properties, in most cases land is not an income producing asset, and therefore cannot carry itself by servicing underlying debt. Without income, land must be underwritten solely upon its current value and/or that of other collateral or guarantees that can be provided.

While the two characteristics of land identified above cause lenders and investors to treat land conservatively, the good news is that the often mentioned quote that "land is a great investment because they're not making any more of it" is one of the great universal truisms in the development world.

Over the years I have seen land financed very astutely and I have also seen financing cobbled together in ways that cripple a project from the outset. The key to understanding how to maximize the financing on your next land transaction is to adhere to the following best practices which will in turn help you realize a more successful project:

1. **Closing**: Close as slowly as the market and/or the seller will allow for: In a perfect world, every transaction would afford you a cooperative seller and little market pressure. This would afford you the opportunity to complete the entitlement work before you close on the land such that you could be fully entitled and permit ready closing the land with your construction loan. The reality is that this is often not the case. Nonetheless, you should structure as much of a delayed or phased closing as possible to generate maximum leverage with the capital markets.
2. **Use of Debt**: If possible, resist the temptation to bring in third party equity to finance the acquisition of the land. Bringing in a partner at the early stages of a project will dilute the internal rates on return available to the investor and require you to give up a greater participation in the project. Whether you use seller financing, bridge financing, letters or lines of credit, collateral pools, tax credits, municipal assistance, a traditional acquisition loan or any combination thereof, do everything possible to maintain 100 percent of the ownership in a project at the initial stages. This will allow you to complete the entitlement work and book the land-lift prior to seeking your equity partner thereby allowing you to reduce the amount of outside equity needed and increasing overall project profit.
3. **Capital Structure:** Use all levels of the capital structure to move up the leverage curve. Once you have secured entitlements and booked your land-lift continue to use as much leverage as possible throughout the balance of the project. By using the proper combination of senior debt, subordinated debt, and third party equity, even in today's market it is possible to realize leverage well in excess of market norms in terms of the percent of the total project cost or value while maintaining control of the investment.
4. **Dilution:** You can also use different levels of the capital structure to prevent project ownership dilution. By using seller carry, second mortgages, bond issues or mezzanine financing to fill as much of the equity gap as possible, you will lower your overall cost of capital while not being forced to give up as much ownership in the project as you would by closing the entire equity gap with an equity joint venture (JV) partner.
5. **Equity:** Negotiating the proper type of equity joint venture can be critical to the financial success of a project is critical. If you move up the leverage curve with the proper combination of senior and subordinate debt, the amount of equity needed from outside investors is minimized. Using the right JV or preferred equity investment structure can leverage the sponsor co-invest to as little as 2 percent to 5 percent of the project equity requirement while still leaving the sponsor with the majority of project ownership.
6. **Selecting Equity Partners:** The decision to select an Individual Investor vs. an Institutional Investor is critical to your capital formation plan. Decide early where you choose to seek your capital partners and investors and be willing to live with your decision. With rare exception, if a sponsor can meet institutional suitability tests, they will be better served by accessing commercial capital markets rather than dealing with individual investors. Institutional investors have more knowledge and flexibility when structuring transactions, giving owners more operating flexibility. Institutional investors have deep pockets and can

provide the appropriate level of financing to allow sponsors to engage multiple projects at one time thereby creating the ability to grow their business with greater velocity when contrasted to the leverage provided by individual investors. Additionally most institutional investors prefer passive investments and will only exercise dilution or control provisions in the rarest of circumstances. Lastly, institutional investors often times can provide tremendous non-financial value adds in the form of knowledge base, intellectual capital, market contacts, and the like.

Understanding how to access and maneuver within the commercial capital markets and effectively leveraging the savvy land financing techniques can be the defining difference in optimizing the scalability and efficiency of your development efforts.

About Us

In 1996, Mark Mayfield and Randy Graham started in business together with Southern Realty in Rock Hill. Mark originally started Southern Realty's commercial division in 1991. Southern Realty was purchased by the Allen Tate Company in 1998 and together Mark and Randy purchased the Commercial Division in April of 1999 from the Allen Tate Company and started their own company – Southern Commercial Real Estate, LLC.

As principals of Southern Commercial Real Estate, LLC ("SCRE"), they have considerable experience in successfully selling and leasing all types of commercial and industrial property in the Upper Piedmont of South Carolina. Mark has over 18 years of experience and a career volume of $108 million in 400+ transactions. Randy has 15 years experience and a career volume of nearly $68 million in 200+ transactions.

With a successful track record and established entity, SCRE expanded its services and national reach on January 1, 2007. SCRE joined forces with a nationally recognized leader, and the fastest growing commercial real estate brokerage firm in the United States, Sperry Van Ness to form Sperry Van Ness/Southern Commercial Real Estate. Founded in 1987, Sperry Van Ness has over 1,000 advisors in the US and internationally providing advisory, brokerage, consultation, asset management, leasing, accelerated marketing and auction services.

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