RICE UNIVERSITY

CREATIVE DEVELOPMENT FINANCING

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IN PARTIAL FULFILLMENT OF THE
REQUIREMENTS FOR THE DEGREE OF

MASTER OF ARCHITECTURE IN URBAN DESIGN

Thesis Director's Signature:

Houston, Texas

May, 1972
To PAT
RAMONA
and ROB....

FOR THEIR PERPETUAL PATIENCE

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Although the development process is often ill-defined and somewhat intangible, there is a definite rationale to the methodology employed to effectuate the creation of our built environment. To comprehend this rationale, it is first necessary to identify and understand the financial infrastructure within which all investment type developments must be perpetrated. Once it is clear that financial restraints play a primary role in determining what, where, and when built facilities will be constructed, it is possible to conclude that financial parameters will also have a major impact on the quantity and quality of built improvements that can and will be made.

The conflicting continuum of profit versus design has long been the dilemma of those who participate in the development process. It is for this reason that many of the professionals who logically should be primary decision makers in the development process have been reluctant to become directly involved in initiation and ownership of income producing real estate projects.

"The seeds of mistrust between the architectural and economic disciplines have long been germinating. There appear to be three reasons: a lack of respect between the disciplines; a
lack of interprofessional knowledge; and poor client coordina-
tion. An understanding of the development processes may well
be a reasonable approach to eradicating many of the misconcep-
tions through which real estate development and financing
procedures are often perceived.

The intent of Creative Development Financing is to give a com-
prehensive overview of the various aspects and implications
inherent to the development process. Special emphasis is
placed on the economic considerations of the developers, in-
vestors, and financial institutions that currently represent
the major contributors to the development process.

The identification and analization of creative financing techni-
ques is undertaken to both enlighten the reader and to demonstrate
that both quality and quantity of improvements on land may be a
direct result of the level of expertise and inventiveness
employed by those establishing the long range economic para-
meters within which the development process is initiated and
perpetuated.

Rice University
May, 1972

1. "The New Environmental Professionals," Progressive
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DEVELOPMENT AND THE CREATIVE PROCESS

INTRODUCTION

In every urban area there exist a diverse group of businessmen, including professional property investors, land developers, speculators, builders, and mortgage lenders whose principal occupation is the day-to-day development of the city. As the primary producers of the built environment, they have a vested interest in real property. Such urban property, either real or personal, represents a significant investment whether in public, private, or semi-public ownership.

From the viewpoint of the private sector, the return on this investment represents the basic motivation and ultimate measure of the degree to which its capital will continue to participate in the urban property market. The major concern is the ability to obtain an adequate rate and volume of return.
as compared to alternate investment opportunities in and outside the realm of urban real estate investment.

What the investment approach fails to recognize is that what and how a developer uses the land he controls will undoubtedly affect the urban fabric at many levels. A basic principle of land economics suggests that for each action, there is not only a single stage use reaction, but also an extended series of chain reactions. The impact and range of development decisions may therefore have a residual effect on the whole or any portion of the total urban environment.

In many cases, capitalistic motivation, combined with existing tax laws that actually encourage a developer to build quickly and often badly, has brought about the development of major segments in urban areas that are of highly inferior quality. "Entrepreneurs, boards of directors and committees make decisions in the United States every year that result in the expenditure of billions of dollars for capital improvements that literally shape our environment without the consultation or advice of an architect."  

CREATIVE PROCESS

The traditional process for creating the urban environment

has been for the developer-entrepreneur to initiate a project, assemble the land, determine the economic parameters and locate the source of financing, without ever defining and/or bringing together as a unified group, the various disciplines that normally participate in the development process. By not having an opportunity to participate in early real estate, financial, and similar decisions, many contributors to the development process have repeatedly found themselves hampered in the satisfactory effectuation of their professional skills and talents, by decisions over which they have no control or influence.

The design professionals, especially, have found themselves at a great disadvantage when faced with the difficult task of choosing between the often self-centered interest of a profit oriented client and an inbred personal desire to protect the interest of the total community, when the two are in conflict.

It is this recurring conflict, combined with the realization that the design professions, on the whole, have had a very insignificant impact on the built environment, that has led many architects, planners and urban designers to the conclusion that a more comprehensive approach to the problems of development must be achieved.

Concurrent with this awakening, developers too have began to change their attitude toward the creative process. This
reorientation may be partially due to the increasing complexity of projects, new values and demands projected by governmental legislation and programs, or merely public focus on the quality of the environment. Primarily, however, it is due to a major revolution now under progress throughout all phases of the construction industry.

Two basic phenomena are responsible for this:

"(1) The technological and resulting economic, social and political changes which the world and especially the United States have undergone since the mid-point of the 20th. Century has resulted in the evolution of projects of increasing magnitude and complexity...

"(2) With population projected to double during the next 40 years and with rapid obsolescence of our decaying central cities, more than $3 trillion of today's dollars will be invested in building construction in this country as we virtually build a second America during the last third of this century."

This enlarged framework calls for developments at a larger scale and over longer periods of time with continuous involvement by all members of the development team. Closer scrutiny must be given not only to design, but to time schedules, budgets, financing, taxation and legal aspects of the project as well. The developer-owner is finding he can no longer move from assumption to decision without first preparing for con-

tingencies that were largely non-existent in the past.

The impact of these phenomena has brought about a redefinition of the creative process and the roles of the various participants. Developers and architects alike, now tend to view the creative process for the man-made environment as a composite of the various functions required for the initiation, conception, implementation, financing and construction of anything that is built or rebuilt.

THE DEVELOPMENT PROCESS

It therefore becomes increasingly important that all participants in the development process have a basic understanding of "how the deal goes together." By understanding the total development process, and recognizing what other members of the investment building team have to offer, individual participants will be able to more effectively contribute the skills which make them unique and essential to the effectuation of the development process. By becoming involved in the overall decision making process, each of these will have an opportunity to assume a key position on the development team, and, in many cases, will have the option of becoming equity participants of investment-type projects.

COMPREHENSIVE DEVELOPMENT

Unlike in past times, the client of today is likely to bring
only his problem to the development team. He may offer no land and little money, be a mere speculator or investor, or own the land and wish to see it profitably developed. It is then the development team's responsibility to investigate the client's problem, advise on the feasibility of development, and eventually bring money, land and the client's development objectives into actuality. The investment sector, will not of course, allow others to assume a major role or degree of control over their private investment decisions regardless of how much they need professional assistance unless they are confident that this group is fully qualified and ready to accept the responsibility for such involvement.

There are numerous ways that a contributor may prove his right to assume a role of significance on the investment development team, but all are based on establishing a record of professional expertise and competence. To evolve such a record, basic concepts of professionalism for all participants of the building team, whether labeled as market analyst, systems engineer, realtor, architect, mortgage broker or construction manager, must be recognized and adhered to by the development professionals. Three basic concepts may serve as a foundation for application of professional services:

"(1) Minimizing uncertainty. A professional service must make a direct contribution to the reduction of the uncertainties involved in managing a business. The proper assessment of a service, unlike tangible goods, usually must take into account
the impact of its performance on the client's business.

"(2) Understanding problems. A professional service must come directly to grips with a fundamental problem of the business purchasing that service. The successful performance of the service, far more than the successful production of a product, depends on an understanding of the client's business.

"(3) Buying the professional service. A professional service can only be purchased meaningfully from someone who is capable of rendering the service. Selling ability and personality by themselves are meaningless."'

Basically, the client or market must be satisfied that the development team can indeed help solve his problems. Regardless of the approach used to effectuate the development process, in the end, what the client wants is favorable results.

FINANCIAL IMPLICATIONS

To become proficient as a contributor to real estate projects, all members of the development team will have to become cognizant of the impact and effectuation of both the real estate and financial aspects of development. An understanding of the requirements imposed by financing is a prerequisite to realizing the full potential of a real estate development project. Where this understanding does not prevail, many of the cost parameters imposed by financing may appear both frustrating

and unnecessary. A basic understanding of the techniques of real estate financing is as necessary to all members of the development team as understanding design and construction is to the lending institutions.

CONCLUSION

"Financing and building a great project is a bit like building a road through mountain country; around every bend there is a surprise, and a great part of the excitement and interest in a development, aside from its conception, lies in the challenge of finding new ways around the many difficulties that crop up."1

At one time, financing a project was relatively simple. The developer either already had the money to build the building or could go to the bank and borrow it. In either case, whether or not the project became a reality depended solely on the quality of his credit rating. Today it is not quite so simple. It is not uncommon for a developer to build a project on land he will never own with money that belongs to someone else and then realize a profit when he sells it to another entrepreneur who only intends to lease it to someone else. It is this complexity that Creative Development Financing is all about.

THE DEVELOPMENT PROCESS

INTRODUCTION
The development process begins with an idea. There are a number of sources from which this idea may emanate. The individual who propagates the idea may be an entrepreneur, an investor, a landowner, a real estate broker, a land planner, or any other individual or group who can recognize a need and a potential for profit through fulfilling that need. Regardless of the initiator's personal aspirations or his societal orientations, it is basically the profit incentive that justifies his participation in the development process. The manner of compensation will vary, but the need to perpetuate one's livelihood is constant.

THE ENTREPRENEUR
The entrepreneur is a generator of productive enterprise. Financially, he may or may not have a great deal to offer.
THE DEVELOPMENT PROCESS

But as an individual he possesses a resource far more difficult to find than capital. He has the ability to conceive, to organize, to generate enthusiasm, and the insight to recognize the light at the end of the tunnel. His job is to assemble the people and the parts, and to fit the pieces together in a manner that will cause the end product to be greater than the sum of the parts. An idea man, and a promoter of ideas, he seeks his reward through participation in ownership, fees for his services, and the satisfaction of knowing that he alone is the ultimate creator and overseer of the development process. The entrepreneur is essential; without him, or his counterpart in the form of any of the development team members, the project remains merely an idea.

THE INVESTOR

The investor has capital, or at least access to capital, to contribute to the development process. His is a prestigious position in our capitalistic economy. Often revered by his economic lessers, he can do no wrong, and if he could, it would only heighten the colorful image inherent to his lifestyle. We live in an age, where, according to his position, a man may be heralded as a delightful rogue, or condemned as a demented criminal, for the same act. Money holds the key to position, power and the potential for perpetual immortality through the printed word.
Even the haves, who often reject or condemn pecuniary pursuits as the root of all evil on the one hand, recognize its omnipotence, and justify its pursuit as a means to perpetrate their own personal or political plight.

Few people recognize the dilemma that accompanies pecuniary predominance. The fear of the rich today, may not be that they will die too young, but rather that they will outlive their wealth. On all sides their fortunes are assaulted. Inflation erodes the value of the dollar, taxes increase, tax brackets move endlessly upward, and everyone and every cause has the upturned palm outstretched.

It is this continuum that makes real estate developments attractive to those who have capital. Real estate offers high earning potential, extensive tax shelter, and an opportunity for serving the needs of society. In some cases, the investor and entrepreneur are one. In others, where they are not the same, one may approach the other with funds or an idea and the development process is initiated.

THE LANDOWNER
The landowner's needs are similar to those of the investor. Instead of cash, however, he holds a nonproductive asset which, even if he owns it free and clear, may represent a significant tax burden. If a mortgage exists on the land, interest and principal may also be high. Raw land cannot be
THE DEVELOPMENT PROCESS

depreciated, so no tax shelter exists, and while the land re-
mains unimproved no significant income will be forthcoming. Fortunately, land in a favorable location will normally appre-
ciate over a given period of time. The gain realized on sale may be more than enough to offset the carrying cost and show the landowner a generous profit. However, a ready buyer is not always at hand and a sizable sale means equally large amounts of taxes to be paid. In other cases, the land does not appreciate as predicted, and the landowner is at a loss of how to dispose of his investment or escape the ever con-
stant carrying charges.

The solution is often a joint venture with a developer. Every-
body wins. The developer acquires the land he must have to develop, and the landowner receives ground floor participation in a venture that offers potential for maximum leverage. The carrying cost is now the responsibility of the joint venture entity, and what was a nonproducing, and cash consuming asset, is now on its way to becoming a highly leveraged, income pro-
ducing property offering cash flow, tax shelter, and eventually capital gains. If the landowner retains adjacent properties, appreciation of values will quite likely be accelerated due to the increased value of the improved properties.

OTHER PARTICIPANTS

The requirements of the other development team members are
often much simpler. They all seek compensation for the particular and essential professional service which they can provide. Where they can leverage their contribution into a share of ownership, they must share the risk, but also stand a chance of realizing a greater return for their investment of time and talents. Of course, the opposite extreme has dominated their participation in past years. The entrepreneurs and investors have often imposed on the professionals to share the risk without offering compensation beyond the normal fee. In such cases, whether they realize it or not, by allowing their fees to be contingent or delayed until the project becomes a physical reality, the professionals have served as a means of financing and leveraging the gains of their more business oriented clients.

Risk

Three basic risks are inherent to almost every type of investment involvement. First, there is the financial risk that once funds are committed to an investment they will not be returned. Second, there is the danger that if they are returned their purchasing power, due to inflation, will have diminished to the point that the funds recovered are worth less than those originally invested. And finally, there is the loss of liquidity, which could mean a corresponding economic loss should the need for converting the asset to cash arise at an inconvenient time.
As the ability of an asset to produce income is the basic determinant of its long-term value, the degree to which an investment type responds to these three risks will ultimately define the rate of return that can be expected. Any reduction in the detrimental impact of these risks results in an increase in the earnings that can be anticipated.

The degree of risk incurred is usually reflected in the amount of compensation an investment will yield. In a free market, low risk involvement normally means a low rate of return. On the other hand, high risk means a higher rate of return. It is to this equilibrium that the money market and sophisticated investors respond.

Real estate investment offers a number of factors which offset much of the basic investment risk. Further, where risk is greatest, real estate investments normally offer an economic return more than sufficient to offset that risk.

Where inflation is concerned, this is particularly obvious. "Real estate income is produced by rents, which are prices, and these prices generally rise with other prices."\(^1\)

Although rent increases actually contribute to overall infla-

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tion, the rate at which rents increase, accelerated by increasing demand, is sufficient to offer a substantial hedge against inflationary trends. The impact of inflation on the purchasing power of the dollar can be demonstrated by the following statements:

"(1) The amount of merchandise that $47 would buy in 1945 would cost $100 today.

"(2) On the other hand, housing that cost $46 in 1945 cost $100 in 1969."

As can be seen, the earning power of the real estate has remained essentially the same, whereas the value of cash has been cut in half.

Real estate is a nonmonetary asset that is normally highly illiquid. Rather than interest being paid, as on a corporate bond, the return is acquired through the potential to realize a profit. As such, the initial investment is not returned at a specified date. The liquidity, or ability to readily "cash in" the investment without sacrificing profit, depends on the salability of the asset at the time of conversion.

Monetary assets are far more liquid than real estate, with varying degrees of liquidity offered by a checking account to less liquid monetary assets such as well-known stocks and

high-grade bonds. "But you can get the most profit by investing in an illiquid asset such as real estate." The ability to realize a profit is further enhanced by tax shelter, cash flow, and capital gains that are particularly associated with real estate investment projects.

TAX INCENTIVES

It is important to recognize that every investor has a silent (or sometimes, not so silent) partner in the form of the United States government. The participation of this "partner" increases as the individual's tax bracket goes higher. As such, the tax implications of an investment may be the primary factor affecting the ultimate rate of return retained by the investor.

"Under the government's present policy of high taxes and liberal depreciation allowance, tax sheltered income property can be an excellent investment." The benefits are increased as tax brackets go up and the percent of downpayment goes down. Taxable income on an investment return is normally determined by subtracting expenses from gross income. Thus the tax deduction allowed for depreciation of real property will often

result in an accounting tax loss for the investor, even though
he actually receives spendable income from his investment. The
apparent loss may be even greater when the interest on money
borrowed is deducted.

Six basic tax advantages are inherent to income producing real
estate property. They include:

1. Depreciation
2. Leverage
3. Sales at Capital Gains Tax Rates
4. Installment Sales
5. Tax Free Exchanges
6. Building Up Values by Tax Deductible Repairs

All contribute to creating a basically tax free return to the
investor. "For the taxpayer in an average 50% tax bracket,
a 20% tax-free return is equivalent to a return in taxable
ordinary income of 40%." An understanding of these tax ele-
ments is essential to successful financial involvement in the
development process.

DEPRECIATION

Undoubtedly the major advantage to real property investors,
depreciation may be defined as the wasting of an asset. Al-
though land is not depreciable, the improvements on it will
suffer a theoretical loss in value each year. In reality, the
property will probably appreciate in value. Nevertheless, the

Property Research Corporation, Pamphlet, 3.
tax laws permit the owner of an improvement to deduct from his annual income, an amount equal to the theoretical reduction in value. This becomes a valuable tool for increasing the after tax return possible to the investor. "Handled properly, the depreciation will usually exceed the net income from the property. So not only might there be no taxable income but there can be a tax loss to apply against other ordinary income. This will, in turn, lower your tax liability and generate a tax refund."

There are a number of techniques that may be used to depreciate real property. To comprehend these methods, it is first necessary to define the following terms:

1) Market Value - the maximum amount of money that a prospective buyer is willing to pay for the property.

2) Value to the Owner - amount that would be necessary to just compensate the owner for depriving him of his property.

3) Book Value or Unamortized Cost - cost of the property less the total depreciation charged to date.

4) Net Book Value - the book value less the cost of non-depreciable items (for example in the case of a building the land on which it sits cannot be depreciated, therefore the net book value is the book value minus the land cost).

5) Replacement Cost - the difference between the cost of a new asset and that of an existing old asset."


There are four basic methods of depreciation commonly associated with real estate.

1. **Straight Line**
2. **Declining Balance**
3. **Sum-of-the-Years Digits**
4. **Component Parts**

The method of depreciation that will be used for a particular property will vary with the investment goals of the property owners. Those investors seeking a uniform annual write off of depreciation will use the straight line technique. Those whose cash flow situation demands a high write off in the early years they hold the property will use the remaining three methods which offer accelerated depreciation rates.

**STRAIGHT LINE DEPRECIATION**

This is the simplest form of depreciation. Once the useful life of an improvement has been determined (that is the number of years over which it will fully depreciate) an annual depreciation allowance may be made equal to the reciprocal of the number of years converted to a percentage and multiplied times the value of the building. Thus a building having a useful life of 40 years has a depreciation allowance of 2-1/2% per year if the straight line method is used. To calculate the annual depreciation, the following formula may be used:

\[
\text{Annual Depreciation} = \frac{\text{Improvement Cost} - \text{Salvage Value}}{\text{Useful Life in Years}}
\]
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Thus a building having an economic value of $10,000,000 and a useful life of 40 years with no salvage value would yield the following annual depreciation:

\[
\text{Annual Depreciation} = \frac{10,000,000 - 0}{40} = 250,000
\]

Total Depreciation = $10,000,000

The owner would therefore receive $250,000 depreciation value each year. At the end of 40 years the full economic value of the building would be used.

DECLINING BALANCE DEPRECIATION

The declining balance method of depreciation is a form of accelerated depreciation that may be used for assets having lives of three years or more. This method provides for a given rate of depreciation to be applied to the net book value of the asset each year. The percentage of depreciation remains the same each year, but the amount of depreciation is declining because the book value is declining. For real estate investments, a 150% or 200% (double) declining balance method may be used to depreciate the improvements on the property. The annual depreciation allowed using these techniques may be calculated as follows:

\[
\begin{align*}
150\% \text{ Declining Balance Depreciation} &= \frac{150\% \times \text{Book Value}}{\text{Useful Life in Years}} \\
200\% \text{ Declining Balance Depreciation} &= \frac{200\% \times \text{Book Value}}{\text{Useful Life in Years}}
\end{align*}
\]
The building having an economic value of $10,000,000 and a useful life of 40 years would yield the following depreciation using the 150% declining balance method:

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation Formula</th>
<th>Calculation</th>
<th>Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Year</td>
<td>150% x $10,000,000</td>
<td>$375,000</td>
<td></td>
</tr>
<tr>
<td>Second Year</td>
<td>150% ($10,000,000 - $9,625,000)</td>
<td>$361,000</td>
<td></td>
</tr>
<tr>
<td>Third Year</td>
<td>150% ($9,625,000 - $361,000)</td>
<td>$347,000</td>
<td></td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Fortieth Year</td>
<td>150% ($2,266,666)</td>
<td>$85,000</td>
<td></td>
</tr>
</tbody>
</table>

Total Depreciation = $7,832,000

At the end of the period of useful life there will remain a net book value greater than zero that may be disregarded and considered salvage value. The 200% Declining Balance method will offer an even more accelerated depreciation for the improvements on the property, allowing a write off of about two-thirds of the depreciation cost of the asset in the first half of its useful life. When the charge off allowed by either of these methods becomes less than that permitted by straight line depreciation, it is permissible to convert to the straight line method so that the entire economic value of the property can be fully depreciated within the estimated useful life of the building.
SUM-OF-THE-YEARS DIGITS DEPRECIATION

This technique writes off about three-fourths of the depreciation cost in the first half of the estimated life and is thus primarily used on equipment and other short life items. The annual depreciation is determined by dividing the remaining useful life of the property by the sum of all the digits up through the number of years of useful life and multiplying the result by the economic value of the property. Thus, for the property having an economic value of $10,000,000 and a useful life of 40 years the annual depreciation would be:

\[
\text{Sum-of-the-Years Digits} = \frac{40 \times \text{Economic Value}}{1+2+3+\ldots+39+40}
\]

The annual depreciation would be:

- **First Year**
  \[
  \text{Depreciation} = \frac{40 \times 10,000,000}{820} = 488,000
  \]

- **Second Year**
  \[
  \text{Depreciation} = \frac{39 \times 10,000,000}{820} = 475,000
  \]

- **Fortieth Year**
  \[
  \text{Depreciation} = \frac{1 \times 10,000,000}{820} = 12,000
  \]

**Total Depreciation** = $10,000,000

This method uses up the entire estimated value except for the pre-specified salvage value, during the asset's estimated life.
COMPONENT PARTS DEPRECIATION

To use this technique the various parts of a building are assigned useful lives and one of the accelerated methods of depreciation is used to compute the allowance. As many parts have shorter lives than the building, per se, the combined depreciation allowance will normally be much higher than would be otherwise permissible in the earlier years. Only first owners of a project are permitted to use this method.

EFFECTS ON CASH FLOW

The significance of depreciation becomes clear if one realizes that it is an expense item charged against the property that is not actually paid out in cash. As such, the type of depreciation used can greatly affect the taxable income, but will not reduce the cash flow. The formula for taxable income further clarifies this:

\[
\text{Taxable Income} = \text{Cash Flow} + \text{Amortization} - \text{Depreciation}
\]

Cash flow may be defined as the "spendable" cash left over from rental income after all operating expenses and mortgage payments have been disbursed. Amortization is the repayment of money borrowed and represents a build-up of equity in an asset. As there was no tax on the money when borrowed, it stands to reason that a deduction will not be permitted when it is repaid. Depreciation represents a return of the original investment and is thus not taxable. Tax rules change, so it is important that
those involved in the real estate field have current and competent professionals to advise them on depreciation and other tax matters.

LEVERAGE

"Leverage is the use of borrowed money to magnify gains and losses."¹ This is applied to real estate through the purchase of a property for a small down payment and then pledging the property for security for the debt. Benefits of appreciation are then realized for the entire property although only a small equity investment was necessary to gain control of it. "For example, if a $100,000 property appreciates two percent a year, this is 2% appreciation on the investment for the investor who paid all cash. But it is 20% appreciation on the investment if you paid $10,000 down."²

Leverage can work for the investor or against him. As long as the property earns at a greater rate than that of the interest being paid for the borrowed money, leverage is favorable and the investor is gaining the "spread" amount on the mortgage debt. Thus, a profit is realized on the borrowed money. On


the other hand, if the reverse ratio of earnings to interest is true, leverage can be devastating to the new investment.

Leverage applies to all types of investments that will offer appreciation. However only real estate offers the leverage advantage allowed from appreciation of the full value of an investment for which only a small equity was invested to buy.

OTHER TAX ADVANTAGES
The existing tax structure also offers significant benefits for real estate investors by allowing capital gains rates, installment sales, tax free exchanges and claiming of tax deductible repairs. Each of these is a complex tax consideration having special conditions that must be coordinated with a particular property if the investor is to receive full benefit from their application. Conditions vary with the type of property involved, the latest changes in the tax regulations, and the individual economic situation of the property owner. As such, an in depth analysis of these benefits will not be attempted here. Consultation with a tax oriented attorney or accountant is the best way to become cognizant of the current tax situation and how it affects a particular investment involvement.

PROJECT DEFINITION
Once the idea has emerged, either a brief "windshield" survey or a series of basic assumptions founded on past experience
in the development field, will be made to determine whether further investigation into the feasibility of the project is justifiable. Experienced developers may rely on no more than what they define as a "gut feeling" toward the viability of a speculative venture. In many cases, such initial observations will prove to be highly accurate and represent far more than random guesses. Responding to years of successful involvement in the effectuation of the development process, a proven developer will often have sufficient knowledge of the needs, markets, competition, and involvement necessary to readily define, promote, and implement a project without a great deal of additional expertise or formal rationale being necessary. He needs only define his goals and examine the resources available for the type of project he has in mind before proceeding into the process necessary to bring a project to physical reality.

After determining the project is worth undertaking, the developer must then begin to bring together the equity investors and the development team, to assemble the land, and to arrange for the financing required to effectuate the project. Most developers will realize that the creation of an economically sound revenue producing property will primarily depend on having favorable results with the following factors:

"a) Market demand for the facilities at a rent capable of supporting the capital investment
"b) Identification of the cost structure best suited to produce the optimum net profit (the most effective combination of income and expenses, including financing costs)

c) The ability of the architect to design a project consistent with the identified cost and specifications

d) The development of the project in the most effective location and the development of stores or other rental units within the project in most effective location relationships to each other.

e) The ability of the owner to control the cost of construction and develop, within the budget, the project as designed

f) Ability of owner to lease or sell project efficiently

g) Ability of owner to finance project economically

h) Ability of owner to operate project efficiently."

ORGANIZATIONAL STRUCTURE

At some point in the early stages of the development process it will be necessary for the entrepreneur, his attorney and/or a tax consultant to determine in conjunction with other equity investors the organizational structure under which the property will be constructed, owned and operated. A number of alternatives are possible, with each offering unique parameters within which the goals of the various equity participants may be accommodated.

Special emphasis must be given to the tax implications of the various organizational forms. Other items that must be considered in selecting a form of ownership include suitability to use, liability of owners, transferability of ownership, permanence, income, risk, control, maneuverability and timing.

In most projects, the mortgage loan cannot be expected to cover all of the project cost. "The difference, therefore, will have to be supplied by equity investors who will own the project, subject to the prior rights of the mortgage money lender."¹

The equity position may be acquired through contribution of land, cash, credit or services and will vary in amount of ownership according to the time and conditions in which the investor is brought into the project. The legal vehicles normally employed for real estate development include:

1. Individual proprietorship
2. General Partnership
3. Limited Partnership
4. Joint ventures
5. Corporation; and,
6. Real Estate Investment Trust.

A number of other variations and combinations are possible, but the basic determination of their value as a legal entity are similar to one or more of the types examined here.

INDIVIDUAL PROPRIETORSHIP

Direct ownership is the most common form of ownership currently employed for real estate ownership in this country. An individual having sole control of the title or "fee" of a property is normally in a highly desirable position. "Having title means possessing various rights to the property, such as the right to use and to exclude others from using, as well as the right to lease to others and to get possession back at the end of the lease. Other rights include pledging the property as security for a debt, as with borrowing under a mortgage."[1]

Basic advantages and disadvantages of individual ownership can be summarized as follows:

Advantages

(1) Tax losses that occur can be used by the owner to shelter other sources of income.

(2) Legal simplicity negates possibilities of penalties or loss of tax benefits often inherent to other forms of ownership.

(3) The individual owner's tax rate may be lower than if corporate form is used.

(4) Owner has sole and absolute control over the investment.

(5) Easy to liquidate.

(6) Confidential.

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Disadvantages

(1) Possible loss of continuity
(2) Unlimited liability
(3) Owner carries total risk of loss.

PARTNERSHIPS

Partnerships constitute the most common business entity used for land development investments. The three typical types of partnerships in use include the General Partnership, Limited Partnership, and the Joint Venture. All of these types permit the ownership of real property by the partnership which, in itself, offers the distinct advantage of being a nontaxable entity.

GENERAL PARTNERSHIP

All partners hold a legal share of ownership and as such are equally liable for the activities of the firm. Primary advantages and disadvantages are as follows:

Advantages

(1) Nontaxable entity.
(2) Profits and benefits passed through directly to partners who file personal income tax returns.
(3) In event of death of one partner, rights to real property held by the partnership remain vested in the surviving partner(s), although they must eventually account to the estate of the deceased.
(4) Real property conveyance must be executed by all partners or under their joint authority.
Disadvantages

(1) One partner may bind the whole partnership in matters of law.
(2) All partners have full liability.
(3) Difficult to transfer ownership.
(4) Partnership is legally terminated on withdrawal, death or insanity of any partner.
(5) Owners may not be treated as employers for tax purposes, so many benefits and expenses are not allowed as tax deductions.

LIMITED PARTNERSHIP

Often considered as the most useful and flexible form of partnership, the limited partnership is composed of general partners and limited partners. The responsibilities of the general partners are identical to those in a general partnership. The limited partners are passive investors who do not wish to take an active role in management of the business. "The limited partnership form enables an individual to contribute capital to a venture and participate in the profits. At the same time he limits his liability to the extent of his capital contribution and does not have to participate actively in the management of the venture, leaving that to the general partner."1

Basic advantages and disadvantages of the limited partnership are as follows:

Advantages

(1) Limited partnership is a nontaxable entity.

(2) Pretax profits and taxable losses pass directly through to the partners.

(3) Depreciation deductions are applicable to needs of individual partners to the extent of their ownership interest.

(4) Offers corporate benefit of limited liability to limited partners.

(5) General partner has unlimited liability but may own limited partnership interest also. He thus maintains management control without interference from limited partners, has ability to "cash out" his limited partnership investment at any point, and may limit his liability by giving the limited interest to a relative.

(6) Death of limited partner does not dissolve partnership.

Disadvantages

(1) Transferability of interest may be restricted.

(2) Market for limited interest may not be wide.

(3) If general partner dies, the partnership is terminated unless provided otherwise in the limited partnership agreement.

(4) If too similar to a corporation, limited partnership may be ruled a corporation subject to double taxation without having had benefits of corporate status.

The limited partnership is often the legal vehicle for the organization of real estate investment syndicates that are formed to bring together a group of individual investors and
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a developer for the purpose of carrying out a particular real
estate development venture.

JOINT VENTURE

This form of ownership is normally thought of as limited in
duration and confined to a specific project, and is most often
used in jurisdictions not having a limited partnership act.
"It is a special combination of two or more persons who jointly
seek a profit in a special venture without any actual partner¬
ship or corporate designation." Under this arrangement the
equity participants designate one or more members of the group
to serve as trustees for the organization. it is then the
trustee's responsibility to hold title for the benefit of
the owners and manage all affairs of the joint venture. Other¬
wise, the joint venture agreement will closely resemble one of
the other forms of partnership agreement as to basic concept and
content.

CORPORATIONS

"A corporation is a creation of the law. It is a legal entity
that is empowered to own property, to contract debts, and to
engage in certain activities." What essentially exist is a

1. Beaton, William R., Real Estate Investment, Prentice-

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legal device that allows a group of individuals to act and be treated as a single person.

Incorporation is relatively easy to achieve, but the various tax and accounting procedures inherent to such organizational structures are complex and constantly changing. The advantages and disadvantages of the various factors most related to real estate investment can be summarized as follows:

Advantages

(1) Incorporation is a simple and flexible form of ownership that allows multiple participation in varying increments which are easily transferred and appraised as to value.

(2) A centralized management team of diversified professionals can be readily organized and easily perpetuated.

(3) Diversification of investments and involvement in a multiple of projects is possible, thus reducing risk for the stockholders.

(4) Separation of "investment" and "dealer" property is easily defined for tax purposes.

(5) Fringe benefits are easily provided and the owner can participate in these as a shareholder or employee.

(6) Corporate shares are usually highly liquid, but liquidity will vary according to the current market or reputation of the corporation.

(7) The corporation is considered by law as a separate person, apart from the individual stockholders whose liability is limited to the value of their stock holdings in the corporation.

(8) Capital for additional or current investments can be readily raised through issuance of shares of stock within the limits of the corporate charter.
(9) The size of investment possible is limited only by the corporation's ability to raise capital.

(10) The corporation can be organized easily on a modest basis but also has the ability for unlimited growth.

(11) Corporate continuity is not affected by withdrawal or death of any stockholder.

(12) Stock may be exchanged for title or mortgages on real estate with the transfer of both held tax free if certain ownership conditions are met.

(13) The corporate tax rate is fixed at 22 percent until the taxable income amount reaches $25,000.

(14) Stock may be used to acquire property with the stock being valued at its current market rate, thus often establishing a higher than normal basis of the property for tax purposes.

(15) Any sale of stock, regardless of the price paid, is considered a capital contribution and is not taxable.

(16) Earnings may be accumulated as required to meet the reasonable needs of the business, normally up to $100,000 or less.

(17) Double taxation may be avoided if "Subchapter S" requirements can be met. This arrangement permits the limited liability of a corporation while being taxed as a partnership.

Disadvantages

(1) Corporate income is subject to double taxation (when received by the corporation and when distributed to the shareholders).

(2) Corporations are closely regulated by controls outside the realm of its own management.

(3) Although easy to organize, organizational cost may be considered high by some investors and promoters.

(4) Capital losses and depreciation allowances cannot be passed through to individual investors or shareholders but may be advantageous to the corporation.
When all factors are considered, the corporate form of organization, due to the limited liability offered, may prove to be the most attractive type of legal vehicle through which real estate development can be coordinated. However, the owning and financing of separate development projects may best be accommodated through use of a limited partnership arrangement that offers significant tax advantages.

REAL ESTATE INVESTMENT TRUST

The REIT has become a major form of ownership for investing in real estate ventures of a large scale. Income derived through this arrangement is nontaxable if the earnings are properly distributed to the individual investors. "The Internal Revenue Code has numerous complex rules which govern the kinds of assets, number of investors (no less than 100), source of income, amount of annual income distribution to shareholders, and other business operations of the trusts." The prime advantage of such an arrangement is the ability for large land developers, owners or mortgage money lenders to diversify the numerous risk related to large scale investments in real estate among a number of projects and individual investors.

THE DEVELOPMENT TEAM

Concurrent with determining the organizational structure under

which the development will be undertaken, the developer will begin making overtures to the various individuals necessary to bring the project from idea to physical reality. These individuals, should the project materialize, will eventually become the key members of the development team, and as the economics of the situation may demand, possibly co-owners of the completed project.

Although the various services required to develop a project may become increasingly specialized as the size and complexity of the development increases, one individual may perform a variety of the required functions simultaneously. As such, the makeup and extent of the development team will vary. The customary procedures in the locale where the project is undertaken, the versatility of the developer and the individuals he aligns himself with, the developer's capital status, and the sophistication of the organization through which he operates will also affect the composition of the development team.

Commonplace members of the team, or at least, functions that must be fulfilled, include investors, market analyst, attorneys, real estate brokers, engineers, the design professionals, (including planners, urban designers and architects), accountants, mortgage bankers, and construction managers. In many cases all of these functions will be coordinated by the developer and his attorney, with the others being brought into the operation as their particular service becomes
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necessary. In other cases, all or part of these individuals will have in depth involvement in the project from initiation to completion.

Functions fulfilled by the key members are basically as follows:

"Market Analyst: the economist, appraiser, or real estate broker preparing the marketability and feasibility studies.

"Attorney: responsible for drafting, reviewing, and negotiating legal papers for construction, partnerships, debt financing, consultant's services, land purchases, sales and leases, corporations, and zoning changes.

"Accountant: general advisors on tax, financial, and business matters, and controllers of income and expense of the developer.

"Real Estate Broker: assist in testing the market, assembling the land, and marketing or managing the development project.

"Mortgage Banker: the broker who can arrange the permanent mortgage financing and interim construction financing.

"Construction Manager: the building contractor who can provide effective cost control during planning and design.

"Planners: the architects, landscape architects, engineers, and urban planners."!

Additional specialist that might be called upon include market researchers, insurance brokers, public relations experts, property managers, and a number of others depending on the type and parameters of a particular project. Whether the various team members are brought into the project early in

the development process as an integrated group, or called upon only when their particular service is required, will vary depending on the entrepreneur's mode of operation and the nature of the individual project.

SITE SELECTION

Once the existence of a potential market has been tentatively established, an idea or how to capitalize on the demand considered, the equity and ownership arrangements defined, and the development team assembled, it is necessary to locate a suitable parcel of property on which the desired improvements can be constructed.

If the entrepreneur, or one of his co-investors, does not already own, have located, or have been offered a property at a suitable location, he will determine the general area in which the site will be located, assess an approximate value he can economically justify for the purchase, and initiate the land search. With the help of a real estate broker, a number of sites may be located and the possibility for their acquisition investigated. From the possible choices, the developer and his team must choose one location most favorable to the project under consideration.

LAND ACQUISITION

Once a site has been selected, the developer will normally try
to gain control of it on a contingent basis, by putting up a cash deposit or option money. At this point he may know very little about the project and even less about the title to the land. Until the site is settled upon it is quite unlikely that the scale, density, economic value and even ultimate use of the development can be clearly defined. As such, the risk as to whether the project will materialize is still very great. To assure that the property is usable, the developer's attorney will draw up the option contract in a manner that provides ample time to confirm that the property is what the project requires, and that its use will not be encumbered by some unknown. The developer can then investigate existing zoning ordinances, deed restrictions, building codes and other restrictions that might affect the use of the site. A title attorney or title company will be hired to assure that the title is free and clear and to provide assurance or insurance to the effect that the developer is actually getting the full ownership rights represented.

The terms and length of the option and the front money available to the developer will usually determine the intensity of investigation that may be undertaken before the land must be accepted or rejected by the developer.

Regardless of the research involved, from an investment standpoint, the risk will remain high until a permanent commitment or an alternative method of securing construction funds is
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implemented. Until that time, only the credibility of the developer and his team members is available to confirm the probability of economic success that can be expected from the project.

PRELIMINARY PLANNING

Having obtained control of the land, the developer must next begin preparation of a "mortgage package". The first step is to approach an architect with the basic ideas, accumulated data on the site including a survey and topographic map, and instructions as to what the developer believes must be provided for if the project is feasible. If a project is a complex or large one, and the developer has adequate resources, he may feel the hiring of an expert land planner can be justified to supplement the architect's design studies. Either independently, or in conjunction with the architect, the developer must decide on the appropriate land use, amount and sizes of improvements to be made, and the extent of features or amenities that he feels desirable for the project.

ECONOMIC STUDY TYPES

To assure that the project is an acceptable involvement for the mortgage lender, the equity investors, and the developer himself, a number of economic study types can be undertaken with varying degrees of intensity depending on the nature and complexity of the project. These studies also help to predict
the actual return on investment that the various financial participants can expect. Some projects will justify socioeconomic studies and extensive market analysis to accurately confirm the nature and extent of the market to which the project will appeal. In other cases, the developer may rely only on his own experience or information gleaned from his competitors. Some of the more common types of Economic Studies recur with sufficient frequency to justify a brief analysis of their content. Among the more common of these are the appraisal, cost benefit study, economic base study, highest and best use study, land use study, market study and market-ability study, and economic feasibility study.

APPRAISAL

The appraisal is an estimate of value on a parcel of property based on specific land uses that already exist or on projected land uses where the property is currently undeveloped. Market studies, highest and best use studies, and an estimate of the absorption rate likely for the finished project must be made prior to the appraisal. The appraiser will normally look at only those factors which directly affect the economic value of the project and will not be directly concerned with the development and marketing plans themselves.

The three basic methods of appraising revenue producing properties include those founded on replacement cost, comparable
sales, and the income approach. From the developers standpoint, the income approach is the only method that reflects the potential for profit to which he is oriented. "This requires an estimate of the net income of the project, which is then divided by the capitalization rate, to arrive at the economic value of the project." In cases where an economic appraisal may be used as the basis for lending mortgage money, capitalization rates will undoubtedly vary, normally within a range of 7 to 12 percent. The greater the risk of the project, the higher the capitalization rate will be. For this reason, in addition to the economic appraisal, the lender will make a cost analysis of the project and then use the lower of these two figures in determining the amount of mortgage money he can lend.

COST BENEFIT STUDY
This type of study often uses both economic and nonpecuniary benefits to determine the value of a project. It evaluates not only a project's ability to produce a cash return, but also the project's impact on the total economy and society as a whole. For this reason, it is normally used by public agencies for evaluating capital improvements such as expressways, rather than for private land development projects which

are oriented primarily to cash producing considerations.

**ECONOMIC BASE STUDY**
Primarily valued as a source of data for land development studies, the economic base study is normally too general and comprehensive to be used as a tool for decisions concerning a specific project. It is more commonly used for an analysis of the economical activity of a metropolitan region and the accumulation of data on the basic economy that will be of value in formulating and supporting urban planning on a broad scale.

**HIGHEST AND BEST USE STUDY**
The purpose of this type of study is to determine the specific land use which will produce a maximum return on investment for a specific piece of property. A number of land development concepts will be tested within the constraints implied by location, zoning, topography, and other relevant factors.

Possibilities that are obviously not feasible will be identified and documented as to the reason they are rejected before more in depth analysis of the more attractive land uses are fully tested. Remaining potential uses can then be screened to determine marketability, before detailed feasibility studies are undertaken. The highest and best use study is a complicated investigation but is attractive to private developers.
because it offers an analysis of uses for vacant land based solely on pecuniary considerations.

LAND USE STUDY
This study represents merely a documentation of the existing land uses of all properties located within a predetermined area. It is made without consideration for marketability or feasibility and may encompass a small area or an entire city.

MARKET STUDY
A market study is made to determine the present and future supply and demand for a specific land use for one or more properties in a specified geographic area. Although the return on investment may not be calculated, this type of study may provide answers regarding the rate of change of supply and demand as related to the particular use being investigated.

MARKETABILITY STUDY
The marketability study will include a market study of similar land uses in the vicinity of a project to determine the supply of competitive properties, and an analysis of the present and future market for the particular land use to be provided. "Three conclusions must be made: (1) sales or rental prices; (2) quantity likely to be sold or rented per year; and (3) special factors such as financing, sales techniques and amenities which
THE DEVELOPMENT PROCESS

will affect marketing. As a calculation of return is not included, this type of study is relatively simple to make.

ECONOMIC FEASIBILITY STUDY

The economic feasibility study is a valuable tool for both the developer and the lender involved with speculative real estate projects. For the developer, it is a means of projecting the potential success of a specific project. For the lender it also serves as a means of determining the amount of permanent debt money which will be loaned on a project. To undertake such a study it is necessary to have a particular development plan for the site in question, a marketability study that indicates land use and probable revenues of the project, and an estimate of the total project cost and time required for completion. From these it is possible to compare future income with the investment cost and thus arrive at a projected rate of return.

A simplified version of the type of Feasibility Study used by developers to determine the rate of return and the economic value of a project would be done as follows:

(1) **Gross Rent:**  \( GR = R \times A \)

To determine Gross Rent, assume per square foot Rental to be charged and multiply times total leasable Area.

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(2) **Net Income:** \( NI = GR - (E + V) \)

To determine **Net Income** compute Gross Rent and subtract annual operating Expenses and an allowance for Vacancies. (Both operating expenses and vacancies can be calculated as a percentage of gross income.)

(3) **Debt Service:** \( DS = \frac{NI}{(1.2\times1.5)} \)

To determine **Debt Service** required divide **Net Income** by the Debt Service Ratio. (Lenders expect net income to be between 1.2 and 1.5 times the debt service.)

(4) **Mortgage Loan Amount:** \( L = \frac{DS}{DSC} \)

To determine the mortgage **Loan amount** divide the **Debt Service amount** by the **Debt Service Constant**. (The debt service constant may be determined by estimating an interest rate and term (number of years) of the mortgage and looking under the Installment to Amortize section of a compound interest table.)

(5) **Required Equity Investment:** \( E = \frac{NI - DS}{ROR} \)

To determine the **Equity investment** required, subtract from the **Net Income available** the required **Debt Service amount** and divide the result by the investors desired **Rate of Return**.

(6) **Project Budget:** \( PB = E + L \)

To determine maximum **Project Budget**, add the **Equity investment amount** to the mortgage **Loan amount**.

(7) **Building Budget:** \( BB = PB - C \)

To determine maximum **Building Budget** subtract from the maximum **Project Budget** the Cost of demolition, grading, utilities, parking and roads, lighting, professional fees, landscaping, personalty, property taxes, financing fees, construction interest, insurance, land and other cost.

Another method of determining the mortgage loan amount and debt service may be used by replacing steps (3) and (4) above with the following three steps:
(a) Economic Value: \[ EV = \frac{NI}{CR} \]

To determine the Economic Value of a project divide Net Income by the current Capitalization Rate. (Obtainable from lender.)

(b) Mortgage Loan Amount: \[ L = EV \times MR \]

To determine the mortgage Loan amount multiply the Economic Value times the lenders Mortgage Ratio. (Normally 67 to 80 percent of the economic value.)

(c) Debt Service: \[ DS = L \times DSC \]

To determine Debt Service multiply the mortgage Loan amount times the Debt Service Constant.

The Feasibility Study for a typical income producing real estate property is given below. For convenience other financial illustrations that follow will use this example as a basis for analysis.

**PROJECT DEFINITION**

A 20 story office building having 17,300 square feet per floor is proposed by a developer. Of the total building area, 80% is available for lease as prime office space at an annual rent of $6.00 per square foot. Determine the economic parameters within which this project may be profitably developed.

**ECONOMIC FEASIBILITY STUDY**

**URBAN OFFICE BUILDING**

(i) Determine Gross Annual Rent:

- Leaseable area = 80% \( \times \) 346,000 = 276,800 sq. ft.
- Annual rent/sq. ft. = $6.00
- Gross Annual Rent = $6.00 \( \times \) 276,800 = $1,660,000
THE DEVELOPMENT PROCESS

(2) **Determine Net Income:**

- **Gross Annual Rent** = $1,660,000
- **Assume Vacancies** = 10% Gross Annual Rent
- **Assume Operating Expenses** = 30% Gross Annual Rent
- **Total Expenses** = 40% Gross Annual Rent
  - = 40% x $1,660,000
  - = $660,000
- **Net Income** = $1,660,000 - $660,000
  - = $1,000,000

(3) **Determine Debt Service:**

- **Net Income** = $1,000,000
- **Assume Debt Service Ratio** = 1.5
- **Debt Service** = $1,000,000 / 1.5
  - = $660,000

(4) **Determine Mortgage Loan Amount:**

- **Assume Mortgage Loan Interest** = 8.5%
- **Assume Mortgage Loan Term** = 40 years
- **Debt Service Constant** = 0.088
- **Debt Service** = $660,000
- **Mortgage Loan Amount** = $660,000 / 0.088
  - = $7,500,000

**ALTERNATE METHOD (Substitute a, b, and c for 3 and 4 above)**

(a) **Determine Economic Value:**

- **Assume Capitalization Rate** = 10%
- **Net Income** = $1,000,000
- **Economic Value** = $1,000,000 / 0.10
  - = $10,000,000

(b) **Determine Loan Amount:**

- **Assume Mortgage Ratio** = 75%
Economic Value = $10,000,000
Mortgage Loan Amount = 75% x $10,000,000 = $7,500,000

(c) Determine Debt Service:
Debt Service Constant = .088
Mortgage Loan Amount = $7,500,000
Debt Service = .088 x $7,500,000 = $660,000

(5) Determine Required Equity:
Net Income = $1,000,000
Debt Service = $660,000
Cash Flow Before Taxes = $1,000,000 - $660,000 = $340,000
 Desired Rate of Return = 20%
Required Equity Investment = $340,000 / 20% = $1,700,000

(6) Determine Project Budget:
Mortgage Loan Amount = $7,500,000
Equity Investment = $1,700,000
Maximum Project Budget = $7,000,000 + $1,700,000 = $9,200,000

(7) Determine Building Budget:
Assume all other costs = 30% Project Budget = 30% x $9,200,000 = $2,760,000
Maximum Construction Budget = $9,200,000 - $2,760,000 = $6,440,000
To determine allowable cost per square foot, for construction divide the Maximum Construction Budget by the gross area of the building.
Allowable Cost per Square Foot = $18.60

Where the project is built for sale rather than to rent, the feasibility study would be based on a probable sales price for the completed project. "The maximum project budget, including direct costs to the developer, should not exceed 80% of the sales price." A discounted cash flow analysis should be used to determine the present value of the various cash flows estimated for each year. Major cost that must be considered by the developer include payments made on mortgages he finances for the lot buyers, operating expenses, construction and development cost, interest on construction loans, brokerage commissions, and income property taxes paid.

As can be seen, the feasibility study is a valuable decision making tool, regardless of whether the project is oriented to eventual lease or sale. In addition to providing an analysis of the projected rate of return it also defines the sales or rental prices of the completed project, establishes a budget to guide the developer and eventually plays an important part in determining the amount of mortgage financing that will be provided for the project.

Although this feasibility study can be made in a few minutes once the required data is assembled, it should be remembered

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that it will only be as accurate as the data and rules of thumb used and as such, should serve only as a preliminary analysis which will be reviewed and finalized by a competent mortgage banker at a later date.

**Sources of Data**

Whereas some projects will justify in depth socioeconomic studies and expensive market analysis to confirm the nature and extent of the market to which they will appeal, others may require only a review of the developers past successful experiences and a brief investigation into information that may be immediately gained from his competitors. One way or another however, the developer must gain enough insight to guide him in assessing the rent and income estimates necessary to accurately analyze the various aspects of the improvements to be made.

In addition to the developer's own files, data can also be obtained from the trade associations and their journals, local mortgage bankers, real estate brokers, property managers, market analysts, and the various sources they may recommend.

**The Mortgage Package**

When the preliminary data has been written up, and the economic analysis finalized, they can be combined with the architects plans to make up a relatively thorough "Mortgage package." Items most likely to be included in a mortgage application
submitted to a mortgage lender are:

(a) Description of Owners and Sponsors

1. Experience
2. Credit Reports
3. Financial Statements
4. Equity Sources

(b) Description of Builder

1. Experience
2. Copies of Construction Contracts
3. Estimated Completion Date

(c) Description of Consultants

1. Identification
2. Experience

(d) Project Description

1. Location
2. Acreage
3. Net Usable Space
4. Gross Area
5. Space Use

(e) Plot Plan

1. Survey and Dimensions
2. Topography
3. Soil Borings
4. Zoning
5. Building Restrictions
6. Building Outline and Gross Area
7. Parking Lots and Stalls

(f) Plans and Elevations

1. Typical Floor Plans
2. Unit Plans per Building
3. Common or Utility Buildings

(g) Cost Analysis

1. Cost Estimates
   a. Land
   b. Fees
   c. Financing
2. Cost Breakdown of Materials and Labor
(h) **Lease Schedule**

1. Rent Estimate
2. Lease Terms
3. Description of Lessee
4. Tenant Expenses
5. Copies of Executed Leases

(i) **Income and Expenses**

1. Estimate of Total Project Income
2. Estimate of Total Expenses
3. Net Income Available for Debt Service

(j) **Land Acquisition**

1. Copies of Land Contract, Deed or Option

(k) **Competition**

1. Competing Land Uses
2. Area Map
3. Prevailing Rent Structures
4. Tenant Characteristics
5. Parking Facilities

(l) **Market Feasibility Report**

1. By Independent Analyst
2. Selected by Lender

Professional quality and precise organization of the material may provide an attractive and accurate looking presentation for promotion of the project and submittal to a lender who can provide a long-term mortgage commitment. Credibility is important, so it is essential that the material presented is basically accurate. As cost and income projections are merely conjectural, it is not until the lender accepts and confirms them as adequate justification for a loan commitment to the project, that the project is truly on its way to becoming a physical reality.
THE DEVELOPMENT PROCESS

THE PERMANENT COMMITMENT

On submittal of the mortgage package by the mortgage banker, a mortgage broker, or in some cases by the developer himself, the lender will examine the information, run a comparative economic analysis, and determine the extent of funds he may commit based on the economic value of the project. If he likes what he sees, and funds for this type of investment are available, negotiations may be started for arriving at an agreeable loan commitment for the project.

If an agreement can be reached, the lender will issue a written commitment to provide permanent financing for the project that will be honored on completion of the building subject to the practical and legal conditions spelled out in the agreement.

"Very few permanent loans on income producing projects are not actually taken through to completion."

The fact that the lender, who commits the greater portion of the financing for the project, also believes that the project is feasible provides a significant confirmation of the basic feasibility of the project as a potential economic success. For this reason, the developer has overcome a major obstacle in the process of bringing the project into reality, and will normally find the value of the venture is suddenly enhanced and the risk significantly reduced. Even though the eventual cost of the construction

and the accuracy of the income projections are unproven, the project now may begin to take on an air of physical reality. When the developer agrees to accept the permanent commitment, he must pay a standby fee of 1 to 1-1/2% of the permanent loan commitment. It may be necessary for this fee to be forfeited if construction on the project is not began within a specified time, if the project is not completed within a specified period, or if the developer elects not to take out the permanent loan as agreed upon. However if the developer does intend to take out the commitment, the standby fee provides sufficient incentive to encourage him to maintain the momentum necessary to bring the project to completion.

INTERIM FINANCING

Having obtained the permanent commitment, the developer may then approach a short term lender to obtain the interim of construction financing needed for actual development of the project. The interim lender looks to the permanent commitment as a guarantee that the cumulative investment made in the project will be repaid by the permanent lender upon completion of the project. These funds are advanced periodically as the construction progresses, and may be used to pay contractors, subcontractors, professional fees, land costs, property taxes, interest charges, and other project costs that come due during the construction period.
Prior to disbursing any construction funds the interim lender will sign a contract with the builder of the project and require that the interim loan agreement be legally recorded. The recordation gives the interim lender a lien on the project which acts as security for repayment of the debt. To confirm the priority of his lien, the interim lender will want to ascertain that absolutely no work has been done on the site prior to the recording. This is to assure that no existing liens, mechanics or otherwise, place an encumbrance on the property ahead of that held by the interim lender.

From this point on, the project will primarily be self financing. Quite often the first draw on the construction funds will be sufficient to cover the costs of the land on which the project is to be built. If so, the developer will be able to recapture a significant portion of his equity investment and thereby greatly enhance the leverage benefits through which much of his profit will be realized.

The builder will have given the lender relative assurance that progress will continue on the job through the posting of performance or completion bonds purchased from a bonding company, for around 1% of the estimated cost of the building. In some cases the builder's personal signature will suffice if his personal assets are sizable. Thus, the builder too has made a financial commitment that further assures the building will be completed. This is essential to the interim lender, because
an incompleted project is expensive to hold and produces no income while delays will steadily increase construction costs.

**TAKE OUT**

Once construction has been completed, and all conditions of the commitment agreement have been met, the permanent loan will be "taken out," the interim lender paid off, and repayment of the permanent loan begins. From here on, the economic analysis of the developer will be tested. If the developer and his development team were right, he and his co-investors may possibly make a highly lucrative return on their investment.

If not, the project may become an economic casualty resulting in foreclosure and loss of ownership.

By the time a developer has completed a project he will have put in a number of months or even years from the day he first negotiated for the land until the project is fully occupied. If he is lucky, he will have made an annual return of 20% to 30% for his efforts and investments. In the meantime, he will have contributed a great deal of "sweat" equity in the form of promotions, negotiations, and collaboration with the various individuals involved in the development process. "The creation of a sound parcel of revenue-producing real estate is .... not only the result of a proper combination of ownership, real estate, engineering and architectural abilities directed toward the acquisition of the land and the designing and construction of effective improvements on it. In addition, a whole
series of decisions founded on experience in real estate leasing, financing and management must be made in such a way as to produce effective compromise within the very narrow limits that mean profit rather than loss."

TOTAL COST

The ability of the developer to control the design and total cost of a development project will ultimately determine the rate of return that will be forthcoming for the equity participants time and investment. To successfully effectuate the necessary control the developer must understand the impact of individual cost elements on the total cost of the project. The impact of time must also be considered.

The total cost of a development project is determined by a combination of capital cost and future cost. Capital cost includes land cost, construction cost, design fees and carrying charges. Future cost include operating cost, real estate taxes, and financing. The time at which these cost occur must be considered when comparing them. As the value of a dollar received today is worth more than one received tomorrow, due to continuing inflation and increased interest rates, values must be converted to their present worth if a correct comparison of cost is to be made. "The formulas relating

present worth and future worth can be found in texts on investment practice. Time value of money tables have been formed from these formulas.¹

To demonstrate the realtionship of various cost to total cost of a project an analysis of a typical twenty-one story Manhattan apartment house containing 160 luxury units was made and is included below. All values have been converted to the present worth to avoid distortion of the actual relationship of the individual elements.²


2. Ibid., 82.
Construction cost has a much smaller impact on the total cost than most design professionals would normally expect. It is for this reason that redesign and technological breakthroughs fail to significantly affect cost of a project to the ultimate consumer. "While technological construction breakthroughs will be forthcoming, it will be discerned that a comprehensive system approach is necessary because only 33 percent of the cost in housing is in the building and utilities while 43 percent is in financing and 25 percent in land and taxes. All must be rationalized -- a 20 percent cut in building cost, about the maximum reduction to be expected, only reduces the consumer's total cost 12 percent (7 percent in construction, 5 percent in financing)."\(^1\)

**CONSTRUCTION DELAYS**

The time required to carry out the construction of a project can have a significant impact on the total cost. "The length of time required for construction of an office or other speculative building, often has a substantial effect on the amount of necessary equity money; a lengthy construction period will reduce the return on equity investment and may even force the investor out of the project."\(^2\) Where excessive delays do

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increase cost, the additional money required must come either from the completed project or the various equity investors themselves. In either case, the rate of return on the initial investment is reduced. For this reason, delaying a project for any purpose is an expensive undertaking. Delays mean cost increase through inflation and rent lost due to postponement of completion and occupancy.

For the past few years, construction cost have gone up from 1/2% to 1% per month. Therefore, any advantage that might occur through lower interest or savings through redesign will normally be more than offset by inflation. "In fact, it can be shown that a one month delay can be justified only if the developer is absolutely certain that interest rates will drop a minimum of one percent."  

A delay of one month also means a permanent loss of about 10% of the annual income from the property. When combined with inflation, taxes, and carrying cost, this may represent a significant amount of additional equity that must be forthcoming if the project is to be completed. As the mortgage available for a project is based on the economic value rather than construction cost, such increases will likely come from equity rather than debt funds.

To demonstrate the impact of construction timing on the equity requirements of a project, the example of the Urban Office Building can be analyzed.

As indicated in the Feasibility Study, the gross income of the project will be $1,660,000 after a 24 month assumed construction period is over. As annual operating expenses and vacancy allowances will represent 40% or $660,000 of this amount, the remaining annual net income that can be expected will be $1,000,000. A tabulation of the financing for the project if the full 24 months is required for construction is as follows:

**URBAN OFFICE BUILDING FINANCING TABLE**

<table>
<thead>
<tr>
<th>PROJECT COST</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Structures</td>
<td>$6,440,000</td>
</tr>
<tr>
<td>Site Improvements</td>
<td>500,000</td>
</tr>
<tr>
<td>Personal Land</td>
<td>197,500</td>
</tr>
<tr>
<td>Land</td>
<td>250,000</td>
</tr>
<tr>
<td>Fees, Insurance, Taxes</td>
<td>650,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$8,037,500</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>INTERIM FINANCING</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage Banker at 2.5%</td>
<td>$ 187,500</td>
</tr>
<tr>
<td>Loan Discount at 3%</td>
<td>225,000</td>
</tr>
<tr>
<td>Construction Interest</td>
<td>750,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,162,500</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TOTAL INVESTMENT</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td><strong>$9,200,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SOURCE OF FUNDS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Receipts</td>
<td>$7,500,000</td>
</tr>
<tr>
<td>Equity</td>
<td>1,700,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$9,200,000</strong></td>
</tr>
</tbody>
</table>
Equity financing equaling $1,700,000 is thus required. However, if the construction period can be reduced by a six month period, the sources of funds for the project would be as follows:

**SOURCES OF FUNDS**

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Receipts</td>
<td>$7,500,000</td>
</tr>
<tr>
<td>Net Income (6 months)</td>
<td>500,000</td>
</tr>
<tr>
<td>Equity</td>
<td>1,200,000</td>
</tr>
</tbody>
</table>

$9,200,000

Thus, for each six months the construction period can be reduced, net income received will offset the equity requirements by $500,000. On the other hand, every six months the construction period is extended beyond the projected 24 months, net income of $500,000 will be lost, and the equity requirements will go up correspondingly. Actually, due to additional costs of extending or supplementing interim financing, the incremental increase may be even more. The impact of time on equity requirements may be summarized as follows:

**SUMMARY FOR FINANCING**

<table>
<thead>
<tr>
<th>Time in construction</th>
<th>Net Income</th>
<th>Equity Invested</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 months</td>
<td>$ -0-</td>
<td>$2,200,000</td>
</tr>
<tr>
<td>24 months</td>
<td>$ -0-</td>
<td>$1,700,000</td>
</tr>
<tr>
<td>18 months</td>
<td>$ 500,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>12 months</td>
<td>$1,000,000</td>
<td>$ 700,000</td>
</tr>
<tr>
<td>6 months</td>
<td>$1,500,000</td>
<td>$ 200,000</td>
</tr>
</tbody>
</table>

In this example, the money required by the equity investors can be reduced by 85% if the time to occupancy can be reduced from 24 months to 6 months. Once the project is operational, the cash flow will be the same regardless of the amount of equity that was originally invested. Obviously, the owners
would prefer to realize their return on the least amount of equity investment possible. As can be seen, timing is a vital factor that must be controlled if investment goals of the owners of an investment real estate project are to be fulfilled.

CREATIVE FINANCING

A great deal of latitude exist for establishing the financial parameters within which a proposed development project can be effectuated. A variety of techniques can be employed to structure the financial package for financing or refinancing a package which allow the investor to direct and control where, how and when his investment return will materialize. As such, the rate of return on the equity investment may be directly affected by the creativeness of those responsible for the financing, refinancing and eventual liquidation of the property.

CONCLUSION

Financial arrangements, tax considerations, and legal implications form a complex network of interrelated parameters that will eventually be the deciding factor in determining the degree of success that the project will attain. As such, it is essential that these elements be explored in depth and their implications fully tested if the project is to accomplish the investment goals of those who support and perpetuate the development process.
SECTION TWO: PROJECT FUNDING
"Historically, real estate development has been an entrepreneurial business heavily dependent on borrowed capital."¹ The details of financing every real estate development project are unique, but certain basic types of financing are inherent to most income producing real estate properties. The primary categories of financing include:

1. Equity Financing
2. Land Financing
3. Permanent Financing
4. Interim or Construction Financing
5. Special Financing

Equity Financing is capital provided by the owners of a real

estate development project. Representing the difference between debt financing and total project cost, it allows the investor-owner to maintain control of a project with a limited amount of investment commitment.

Land Financing provides funds for the purchase of raw or improved acreage for development purposes. It is normally provided by the landowner-seller, private investors, or to a lesser degree, institutional lenders.

Permanent Financing, provided by long-term institutional lenders, makes it possible to fund major scale capital improvements by extending the repayment period over an extended span of time. Although advanced only after a project is completed, a commitment from the lender that permanent funding will be forthcoming, is sufficient collateral for securing the necessary construction funds for effectuation of the project.

Interim or Construction Financing provides funds for the actual development and construction of the improvements on the land. It is normally provided by a short-term institutional lender who looks to the permanent commitment for assurance that his investment will be returned once construction of the project is completed.

Special Financing, including Standby, Gap, and Combined financing, provides additional funding in unique situations where it is necessary to supplement or supplant other types
Conditions of all of these financing arrangements are negotiable between the lender and the borrower. For each project the financing package must be tailored to accommodate the special considerations inherent to that particular investment involvement. However, a general analysis of the various factors that must be considered will provide an understanding of the parameters within which the elements of development financing may be organized.
EQUITY FINANCING

INTRODUCTION

Almost all real estate development projects undertaken under the conditions of today's money market will require the use of both equity and debt financing to some degree. Debt capital is money borrowed at a fixed rate of return for a certain number of years. As security for the investment, the lender will normally hold a mortgage giving him a lien against the property and improvements. Equity capital is the investment of the owners and represents the difference between the borrowed debt and the total project cost. Which type of funds should be obtained first will vary with the project and the reputation of the developer who is promoting the venture.

A proven developer with established financing connections may find it advantageous to obtain a commitment for permanent
financing prior to seeking equity investors. A feasibility study showing that the project is economically attractive and an indication that equity funds will be forthcoming is all that may be required to obtain the commitment, when viewed by the lender in the light of the developer's past accomplishments.

The ability to acquire such a commitment places the developer with a "track record" at a distinct advantage over his less established contemporaries. He is able to significantly reduce his own front end cost and, using the permanent commitment as an indication of the soundness of the project, to effectively attract additional equity capital for a much smaller piece of the action than would otherwise be necessary. In some cases, a developer in such a position may be able to "mortgage out," allowing him to work totally with borrowed money while retaining full ownership of the project.

The nature of real estate development is such that it is often impossible or uneconomical to finalize all elements before proceeding to the next step. Because of this there are more uncertainties involved and more risk existing at the earlier stages of project development. The inevitable result is that equity investors demand a greater degree of participation if brought into the picture at the earliest stages. It is therefore, advisable for the developer to acquire equity partners only when absolutely necessary as a means of continuing the project. If a project is a sound one, risking a limited amount
of one's own capital and credit should not offer an unreasonable burden to the developer.

An individual who has not yet had sufficient experience to establish an acceptable "track record" may find it difficult to put together both equity and debt financing for his early ventures. "It is often said that investors are quick to lend to anyone who does not need the money (such as a recognized developer with an excellent credit rating)."¹ For those who find themselves in this position the only thing to do is plan a highly attractive project and initiate a hard sell campaign to promote the funding required.

Throughout the development process, the better financed a developer is, the better off he will be. "A few dollars in the bank will help the builder withstand tenant pressures, drive harder bargains with suppliers, hold his land site a little longer until he can get better zoning, await a turn in the mortgage market for financing, etc."² The less reserve the developer has to call upon, the greater the danger that he may eventually lose all or part of the control of his project. For those who do not possess the required financial base, it may be wise to align themselves with someone who does.


SOURCES OF CAPITAL

Finding investors to share in a soundly planned real estate investment, in a good location, and backed by a responsible developer is not a difficult task. Two basic forms of equity participation are normally available. There are some who furnish cash equity and others who provide equity in the form of property, services, or special financing arrangements.

Those in the first group may include friends and relatives, clients, business associates and other individuals interested in putting their money to work to earn a substantial return. Investment, commercial and mortgage bankers often have individual or corporate investors who seek outlets for their investment funds. In recent years, major corporations have began to use their ability to raise money in the stock market as a source of equity and debt capital to be put into real estate investments. Bonds and syndicates may also provide group funds for equity investments. The developer's own sources of cash, including earnings from other projects or business activities, should also not be overlooked.

Those providing noncash funds may include the landowner, professional participants in the project and/or mortgage lenders. Landowners may elect to take equity interest or property. Architects, lawyers, contractors, and real estate brokers may accept participation in a project in lieu of their professional fees. When combined with the cost of the land, these fees will
often represent the total equity required for the development. In recent years, various creative financing arrangements which provide 100 percent financing of a project in return for an equity kicker for the lender have become commonplace.

Where noncash equity is provided it is important that the degree of participation permitted properly reflects the value of the property offered or services contributed and the degree of risk commensurate with the time of involvement. In many cases, the fee for professional services is contingent upon actual realization of the project. Unlike the landowner, whose land appreciates from planning and publicity whether or not the project is effectuated, the professional incurs the risk that his fee will not materialize if the project proves infeasible, plus the risk related to loss of future work.

The valuation of services should therefore be based on both the customary compensation for the service and an additional amount adequate to offset the degree of risk incurred. For protection, the professional should insist on a written commitment for such participation before providing the service.

The developer's own contribution to the project must also be recognized as equity investment. Proper evaluation of his skills and their residual impact in causing the land to appreciate must be carefully weighed if their proper value is to be allocated. Overpricing of this contribution will make it
difficult to attract additional cash investors whereas under-pricing will mean too little return for the risk incurred.

DEBT TO EQUITY RATIO

In addition to the various sources of equity funds, the developer should give adequate attention to achieving the proper debt to equity balance for a project. Too much equity means loss of leverage for his investment; too little may mean overfinancing which will increase debt service to the point that the project becomes unnecessarily risky. The goals of equity and debt investors are in contradiction as to what this balance should be. Equity participants desire to reduce their liability, especially toward the mortgage debt, whereas lenders seek to secure personal liability for the loan from all equity owners involved in the project.

The developer may resolve this by predetermining the amount of equity and debt financing required, providing evidence to justify the size of the loan sought, and devising an ownership agreement tailored to the specific needs of the equity investors involved.

RETURN ON INVESTMENT

"Cash investors typically seek a combination of four types of return on their investment. These return types are as follows:

1) Cash income from operations, typically paid annually, quarterly, or monthly.
"2) Tax shelter, i.e., the ability to deduct losses from personal income taxes.

"3) Value appreciation realized from refinancing; to cash out tax free equity buildup and appreciation in value . . .

"4) Value appreciation realized from selling the project. Gain on sale is usually eligible for long-term gain treatment."

A preliminary estimate of the equity investor's annual rate of return can be obtained using the following formulae:

(1) **Net Income:** \( NI = GR - (E + V) \)

To determine **Net Income** compute **Gross Rents** and subtract annual operating **Expenses** and an allowance for **Vacancies**. (Both operating expenses and vacancies can be calculated as a percentage of gross income.)

(2) **Cash Flow Before Taxes:** \( CFBT = NI - DS \)

To determine **Cash Flow Before Taxes**, subtract from the available **Net income** the required **Debt Service**.

(3) **Taxable Income:** \( TI = NI - (D + I) \)

To determine **Taxable Income**, subtract from the **Net Income** the allowable annual **Depreciation** and the amount of **Interest** paid annually on the mortgage.

(4) **Tax or Tax Benefit:** \( T = TI \times TR \)

To determine **Tax** (positive) or **Tax Benefit** (negative tax), multiply **Taxable Income** by the **Tax Rate** of the equity holder(s).

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(5) **Cash Flow After Taxes:** \( \text{CFAT} = \text{CFBT} - T \)

To determine Cash Flow After Taxes, determine Cash Flow Before Taxes and subtract the computed Tax or add the computed Tax Benefit.

(6) **Cash Rate of Return:** \( \text{CROR} = \frac{\text{CFAT}}{E} \)

To determine annual Cash Rate of Return divide Cash Flow After Taxes by the amount of Equity.

(7) **Total Rate of Return:** \( \text{TROR} = \frac{\text{CFAT} + \text{AM} + \text{AP}}{E} \)

To determine Total Rate of Return (cash and noncash) add Cash Flow After Taxes to the Amortization portion of annual debt service and the amount of estimated Appreciation and then divide by the amount of Equity.

To demonstrate the calculation of the equity investor's annual rate of return, the example of the Urban Office Building can be analyzed.

As indicated in the Feasibility Study, the annual net income will be $1,000,000 and the debt service required is $660,000 per year. For convenience, it will be assumed that ownership is by one individual who is in a 50% income tax bracket. As the project is an office building, the 150% declining balance method of depreciation will be used. For the office building, based on an economic value of $10,000,000, the depreciation allowance for the first year was calculated as $375,000. The return on equity for the first year may be calculated as follows:

**PROJECTED RETURN ON EQUITY**
**URBAN OFFICE BUILDING**

(1) Determine Net Income:
EQUITY FINANCING

Gross Annual Rent = $1,660,000
Total Expenses = $660,000
Net Income = $1,660,000 - $660,000 = $1,000,000

(2) Determine Cash Flow Before Taxes:
Net Income = $1,000,000
Debt Service = $660,000
Cash Flow Before Taxes = $1,000,000 - $660,000 = $340,000

(3) Determine Taxable Income:
Net Income = $1,000,000
Depreciation = $375,000
Interest at 8.5% = $637,500
Taxable Income = $1,000,000 - $101,250 = $1,250 (Tax Loss)

(4) Determine Amount of Tax:
Tax Loss = $1,250
Tax Rate = 50%
Tax Benefit = $1,250 x 50% = $625

(5) Determine Cash Flow After Taxes:
Cash Flow Before Taxes = $340,000
Computed Tax Benefit = $625
Cash Flow After Taxes = $340,000 + $625 = $340,625

(6) Cash Rate of Return:
Cash Flow After Taxes = $340,625
Equity Amount = $1,700,000
Cash Rate of Return = $340,625 / $1,700,000 = 20.0%
(7) **Total Rate of Return:**

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow After Taxes</td>
<td>$340,625</td>
</tr>
<tr>
<td>Amortization</td>
<td>$66,000</td>
</tr>
<tr>
<td>Appreciation at 2%</td>
<td>$200,000</td>
</tr>
<tr>
<td>Equity</td>
<td>$1,700,000</td>
</tr>
<tr>
<td><strong>Total Rate of Return</strong></td>
<td><strong>$593,000</strong> / $1,700,000 = 34.9%**</td>
</tr>
</tbody>
</table>

"The skill in dealing with equity investors lies in the ability to develop the proper balance of cash income, financing proceeds, tax write offs, and the risk of Liability." The developer should therefore emphasize those features most attractive to the particular type of investor he is approaching for equity funds. By fractioning off the separate values of a property and structuring his offerings in price ranges within the financial capability of individual investors, he may secure maximum equity participation without difficulty.

**SPECIAL CONSIDERATIONS**

When securing equity capital the developer must also keep in mind the demands of the mortgage lenders with whom he is dealing. Special attention should be given to the equity offerings impact on land financing, cost over-runs, equity split and

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EQUITY FINANCING

future distributions of income.

A determination must be made as to who will purchase and eventually own the land. By purchasing the land himself, the developer may then lease it to the investment group and thus allow them to use the rent deductions as a tax shelter. The developer owns a nondepreciable asset, but receives the rent payments to provide a return for his investment.

If construction costs exceed the amount of equity and debt funds initially available, additional capital must be provided if the project is to be completed. On the other hand, when the permanent loan is closed, there may be funds in excess of those required for development. It is important to define clearly what action will be taken in either event. There are several approaches commonly used to accommodate these potential problem areas.

In some cases, the developer may assume the over-run risk himself, on the condition that he will receive all cash not expended on construction. Another arrangement permits the developer to assess all equity participants for cost over-runs and in turn split, on a pro rata basis, all construction loan cash not spent. A final solution would be for the developer to set up a cost over-run loan from his own funds to be repaid from future cash flows. By predetermining whether these techniques, or variations of them will be used, misunderstandings between the developer and project investors
can be prevented.

The method adopted for equity split used can be especially important to the investor who receives a share of a project for which he offers services in lieu of cash. To reduce the possibility of a tax liability resulting from such an acquisition, extreme care must be used in determining the percentage of ownership permitted for the developer's services. If the project is tax shelter oriented, the developer will undoubtedly take the greatest portion of his share in fees and rents which are tax deductible items, leaving a small cash flow and large tax deductions for the equity investors. Where cash flow receives emphasis, the developer might reduce the amount paid in fees, forgo receiving rents, and take a high percentage of ownership instead.

The distribution of proceeds from refinancing and future sales will normally be done on a pro rata basis according to ownership. If tax shelter is the primary interest of equity investors, the developer may maintain the bulk of such income for himself.

**RISK**

Experienced developers normally try to avoid bringing in additional equity investors until absolutely necessary. As equity investors entering the picture at the early stages of the project will require a larger percentage of participa-
tion in return for their capital, the developer will be able to retain greater control and eventual return if he uses his own credit whenever possible. As the project progresses, the risk is reduced and those coming into the deal have less justification for being so demanding. The original investors who take the risk of getting the mortgage commitment, options, surveys, zoning changes and other costs deserve to receive a greater percentage of the project's profits.

When the developer shields cash investors for personal liability in his offerings, he should receive more cash for each share of the project than would otherwise be required. In addition, to designing the investment package to meet the needs of individual investors, the developer should select the type of ownership vehicle that will properly pass through the degree of liability and tax shelter desired by the investors.

A proper balance assures that both developer and investor will receive a fair portion of the returns commensurate with the risk they assume. "The proper balance depends upon project merits, the investor contacts established by the developer, and his negotiating ability."[1]

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CONCLUSION

The developer must provide not only the professional skills required to bring about the development, but also must be capable of serving as coordinator of both the equity and debt financing groups. In addition to maintaining a general overview of the entire process, he must also have an understanding of a number of highly specialized elements of the whole.
INTRODUCTION

The availability of adequate land in a favorable location is a key element for initiation of the development process. Whether sought to satisfy a predetermined land use or acquired prior to a determination of its eventual use, land is essential if development is to take place.

Location is the primary consideration in selecting a site for development purposes. It is the location of a project and the arrangement of specific uses within the parameters of the development that will ultimately determine the degree of success it will attain. A unique quality of land is that no two parcels will be absolutely identical. Even adjacent parcels of similar size will have different values depending primarily on the potential for improvement individually inherent to each...
of them. It is such individuality that creates competitive real estate values.

An experienced developer will be sufficiently familiar with the community in which he operates to know the general rental market and the general cost required to develop. Using past experience and rules of thumb it is not difficult for him to recognize what areas in the community will contain the market to which he wishes to appeal. He can then approach a few commercial real estate brokers, indicate the approximate price he is willing to pay for land, and request that they find sites which are suitable to his goals.

SITE ACQUISITION

"The acquisition of land for development is a complex business transaction requiring more than a surface knowledge of land use regulations, mortgage financing, building cost, designs and real estate markets." For this reason, an experienced, full time developer is at a distinct advantage over less experienced or part time entrepreneurs who also seek land for development purposes. Properly identifying, collecting, and analyzing the facts required to acquire a choice parcel of land is a difficult task.

This difficulty is further accentuated by the reluctance of many top-flight real estate brokers to deal with anyone other than full time entrepreneurs. Such reluctance of the realtor is not entirely without justification. A full time developer must maintain an adequate supply of land if he is to stay in business. As such, it is inevitable that he will eventually make the necessary land purchases. Further, to sustain an adequate land inventory, the professional developer will normally be willing to pay the going price for a property without endless bargaining or delay. In fact, his working knowledge of land values may make him suspicious if land prices prove to be significantly lower than those seemingly proper for the current market. Good land is not cheap, and such developers are more interested in finding land they can do something with than acquiring what to the novice would appear to be a bargain.

A site which is off the beaten path, or not yet ripe for development, may eventually cost the developer more than the amount saved through the original purchase. "The wise builder pays top dollar for his land because experience has taught him that a saving of 25% on land cost cuts the final cost of the project by 5% or less." This is true because

the land cost will not normally exceed 20% of the total development cost.

In any event, the capacity of a desirable site to yield a larger loan amount will probably mean the excess cost will come primarily out of the mortgage proceeds granted. If a less desirable site is purchased, the financing ratio may not be as high and the time loss in achieving a full occupancy of the project will undoubtedly mean the revenue lost will come out of the pocket of the developer.

The inherent value of a site which has the ability to "romance" the lenders and attract tenants should not be overlooked. At the other extreme, paying a price that is out of line with the proposed land use and upsetting to the proposed economic analysis of the project can be equally damaging to a project. No matter how attractive a location is, or how well designed the improvements on it, if the bottom line figures on the account sheet are not acceptable, the project may be doomed to failure.

The broker dealing with full time, professional land developers need only be concerned with matching the desire of the entrepreneur for land with the requirements of a landowner in order to make a sale. On the other hand, a part time investor is not under pressure to make a purchase and may tie up the broker for an indefinite period without any assurance that a sale will take place at all. As it is the landowner, that usually pays
the commission to the broker for arranging a sale, spending
time with investors who are not obligated by financial neces-
sity to buy, may very likely prove to be an unprofitable under-
taking.

Occasionally, real estate brokers will approach established
developers with offering of "desirable" land sites whether
requested to do so or not. Such offers give a developer con-
stant exposure to available sites in his community that may
prove useful in the future even if they are not suitable for
use in his current projects.

Regardless of who initiates the land search, the developer
must choose that parcel or parcels he considers in the best
available location for his project and then proceed to gain
control of the land. Once control of the land has been gained
by a developer, he then has valuable collateral that may be
used to obtain financing for his development project.

**SOURCES OF FINANCING**

Land investment is a high leverage business primarily dependent
on the security of the land to offset the risk incurred. "The
purchase of land is rarely financed by the traditional institu-
tional lenders - life insurance companies, savings and loan
associations, savings banks, and commercial banks. However,
other institutional lenders and some private lenders that are
part of the development process occasionally make land
LAND FINANCING

loans. There are four basic sources for financing raw land:

(1) Direct loans from banks and saving and loan associations.

(2) Mortgage bankers or mortgage loan correspondents representing a lending institution.

(3) Mortgage brokers who can place a loan with an institution or private investor.

(4) The seller-landowner.

On approaching an institutional lender, the developer may find that acceptable financing is not readily available for the purchase of raw acreage. This is primarily because raw land has little or no economic value or earning power per se. It is the use to which land can be put that determines its economic value. Regardless of the development potential of a piece of land, until improvements have been made sufficient to establish an acceptable economic value, the lender must view investment in raw land as a high risk one offering little or no collateral, and having virtually no earning power. "In order for land to be productive and income yielding it must be combined (improved) with capital and labor." 2

When lenders do make loans on undeveloped land, they normally


limit the amount to around 50% of the land's appraised value based on the highest and best use of the property at the time of the loan. They also may charge one or more extra discount points to offset the highly speculative nature of this type investment.

Such unfavorable terms will normally prevent a developer from seeking land acquisition funds from institutional lenders. However, if funds are needed to pay off an outstanding purchase money mortgage, to overcome other financial difficulties, to avoid tying up his own capital in land not yet ripe for development, or, where he already owns the property, to obtain working capital for construction on the site, he may have no other alternative.

On the few occasions where an institutional lender will make a favorable land acquisition loan, it is because he feels such involvement will lead to additional financing of a less risky nature if the project is carried through. Private investors are attracted to this market because of the high return they can earn through making such high risk investments. In most cases, however, the landowner himself will be able to offer the best financing terms as he can retain the land itself as collateral.

The financial arrangement a developer is able to make may be a prime determinant in establishing the price he is willing
to pay for a parcel of land. He may be more willing to pay a top price if he is able to do so with other people's money. By using the maximum financing available and obtaining the longest purchase mortgage possible, the developer may be able to purchase the land with little or no cash outlay on his part. "If the ultimate price is high, builders may be able to convince sellers that since the builders are going to spend considerable funds on plans, architectural specifications and rezoning, all benefits which will inure to the seller, even if the builder flops, the seller should accept these costs in lieu of cash on contract."¹

Where the developer does not require that the land be subordinated to a construction loan, the seller may be willing to take as little as 5 to 10 percent cash and a long-term purchase money mortgage. As he retains the land for security the seller runs little risk and will ultimately gain if the developer can get him the price he wants for the property. During the process of rezoning, financing, and planning the developer may assume the processing cost as well as the taxes and carrying charges the owner might otherwise have to bear. Once full control of the land has been attained by the developer. He will have valuable collateral that may be used to obtain additional

financing. Where the landowner will not subordinate his rights to the land to a mortgage lender the construction financing may not be sufficient to recapture the developers front end cost and thus his capital will remain tied up until the project is in operation.

FINANCING TECHNIQUES
The financing techniques used to acquire land are extremely important to the feasibility of development. All methods seek to defer cash outlays for as long as possible and to protect the developer from loss should the project not materialize. A developer will seek to minimize his downpayment, obtain a maximum amount of property release for the downpayment, tie up as much land as possible for the least investment, and provide for maximum flexibility in future dealings with the land.

By minimizing cash outlay and future obligations he can greatly reduce the risk involved at the outset of a project. The leverage inherent to such arrangements is also highly attractive. The more common methods used to accomplish these goals include:

(1) Land Option
(2) Deed and Purchase Money Mortgage
(3) Land Contract
(4) Joint Venture
(5) Ground Leases

LAND OPTIONS

Land options, like the properties they secure, will vary greatly according to the circumstances and the individuals involved. In general, an option gives the holder the right to buy the piece of property at any point within a specified time period at a predetermined price. The cost of the option will vary, but normally represents a very small percent of the total cost of the land.

An option allows a developer to tie up valuable land for a definite period of time for a very modest sum. If the zoning, financing or other requirements the developer needs fail to materialize, he stands only to lose the sums expended to date and the amount of the option money rather than a downpayment on the land that would undoubtedly be substantially larger. By locking in the price of the land the developer stands to gain if the property appreciates during the option period. An option offers certain tax advantages as well. If the option is exercised, the cost is added to the tax basis of the property. If not exercised, the option amount may be classified as a tax loss used to offset other income.

When options are granted that extend over a long period of time it is not uncommon for the seller to require a clause in the contract which allows him to benefit from anticipated
appreciation of the property. This may be accomplished by requiring the developer to pay additional amounts to keep the option open or by periodically escalating the option price at prespecified intervals. The developer's additional cost is offset by the appreciation in the value of the land over the extended period.

Basic variations of the land option include:
(a) Straight Option
(b) Declining Credit Option
(c) Rolling Option
(d) Staged Option
(e) Combination Installment Sale and Option
(f) Speculative Option

A straight option allows the developer to tie down a piece of land for a designated period of time with the right to buy at any time during the option period for a specified price. If the market price of the land is rising, the price specified by the option may be higher than the current appraised value of similar properties in the area. This actually offers little additional risk or cost as the land is expected to increase in value anyway. By the time of purchase it may be even greater in value than the option price. Under a straight option the owner continues to pay all taxes and carrying charges and the cost of the option is applied toward the total purchase
price on execution. One variation of the straight option is an arrangement where the specified amount to be paid for the property goes up each year the option is held and not exercised.

A **declining credit option** calls for a specified payment to be made at the outset on an option to be held for a predetermined number of years. If the option is exercised during the first year the entire amount is applied toward the purchase of the property. For each succeeding year the option is not exercised, the option amount applied toward the purchase price is reduced by a specific increment. This provides incentive to the developer to exercise the option and somewhat accommodates any appreciation in the property value that might occur.

A **rolling option** is normally used to tie up a large tract of land that is to be developed in incremental fashion. An option is placed on the entire property which is then divided into mutually agreeable parcels having the same or individually specified purchase prices. The developer may have a free choice as to which parcel will be purchased or an order of acquisition may be designated. On purchase of the first parcel the developer has the choice of paying the designated purchase price in cash or allowing the entire amount paid for the option to be applied toward the purchase price. In the latter case, use of the option deposit toward the purchase releases the option on the remaining parcels. If the full purchase price is paid the option is retained and the option deposit is allowed
to "roll over" to the remaining parcels. This technique provides maximum flexibility and minimum commitment for the developer.

To protect the owner, the price of the parcels purchased first will be sufficiently higher to offset the risk the owner takes that the developer will develop the choice parcels and then let the remaining parcels go. The landowner also stands to gain through appreciated values of his remaining property due to development of the adjacent ones.

A staged option provides the developer assurance that he will have an adequate supply of land to develop within the period of the option, in stages. By purchasing in stages the developer can avoid tying up his capital in land which he cannot immediately develop. This permits him to use his capital to fully develop one portion, and then when his capital is recaptured through sales, to proceed to the next.

Using this technique the landowner will normally get a higher price for his property than that possible by an outright sale and he also avoids the excessive tax that would occur should the income from the sale of the tract have to be reported in one year.

A combination installment sale and option may also be used to sell large tracts of land to developers who prefer to develop under a staged program. An accurate survey is made to determine the quantity of land and a price per acre is established. After
the developer signs a contract agreeing to purchase a minimum percentage of the total acreage, the land is conveyed to him. The land remaining is placed under an option that must be exercised according to a mutually agreed upon time schedule.

In some cases, speculative options are obtained. Where this occurs, the would be developer gains control of the property then shops around for a buyer at a price higher than that stated in the option. He thereby uses leverage to turn his modest option cost into a sizable profit. For the sale to qualify as capital gains the promoter must be sure it is the option he sells rather than the land if the six months holding period required by tax regulations is to be satisfied. Where a developer does intend to develop the land which he holds an option on, he will normally not "commit himself to purchase or pay carrying charges on more land than he can anticipate using within the next 18 months or two years."  

DEED AND PURCHASE MONEY MORTGAGE

A purchase money mortgage is used if the landowner is willing to provide a portion of the financing required to purchase his land. A mortgage is an instrument which creates a lien upon the property which provides security for repayment

of the loan amount. The normal procedure is for the developer to make a downpayment on the land with the balance on the purchase price due at a later date. The owner transfers title to the land and receives a purchase money mortgage for the outstanding amount of the land cost.

If the land is not sufficient collateral for the loan, a promissory note may be included to further guarantee repayment of the loan. A promissory note is a written promise by one person to pay, unconditionally, to another person a certain sum of money at a specified time or on demand. In most cases, however, the land will offer sufficient collateral for financing by the landowner-seller and the developer will thus insist that the contract states that the land is the sole security for the outstanding loan amount.

Should the developer become unwilling or unable to continue carrying the land, he may default on the contract and walk away from the investment without loss beyond the amount of his downpayment and whatever fees, time and cost he has expended up to the date of the default. The landowner-seller must then foreclose to enforce payment of the debt secured by the purchase money mortgage. If he chooses to buy in at the foreclosure sale he may resume his position as sole owner of the land. In addition, he will have realized a profit from the developer's downpayment and from the payments on the purchase price, and will realize the benefits of any appreciation or
improvements that the developer might have made on the property.

The advantage of a purchase money mortgage to the landowner is that it allows him to use the installment or deferred method of reporting his gain. Current tax laws provide that if the seller receives no more than 30% of the sales price in the first year of sale, the transaction qualifies as an installment sale and the seller is permitted to report his profit year by year instead of all in one year.

Another reason a landowner might enter into such an arrangement is to make it possible for a developer who cannot arrange other financing to purchase the property. Whether this is due to a tight money market or the risky nature of the project the developer has in mind, the seller will normally require a higher selling price in addition to the interest he will receive on the purchase money mortgage. "In some cases very generous provisions may be obtained - a low downpayment, a long term, and maybe even subordination of the loan to a long-term first mortgage from an institutional lender - but they are usually reflected in a higher price than would be paid on an all cash basis." This additional cost, effectively a form of discounting, is acceptable to the developer as it makes it possible for him

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to purchase the land with a small cash outlay allowing him to obtain greater leverage on his investment.

If added flexibility can be provided in the purchase-money mortgage contract, the value of the property to the developer will be enhanced. To enable the developer to sell off or develop certain portions of the land as required, an arrangement can be made to permit selected parcels of the land to be released for development or resale upon payment of a proportionate amount of the mortgage principal. Using this partial release technique, the proceeds from sale of the developed property may be used by the developer to cover the cost of carrying the land. The amount of profit possible to the developer then depends upon his ability to sell quickly and profitably, thereby shortening the time the land must be carried and reducing the carrying cost.

For many years developers were allowed to prepay as much as five years of interest payments and then deduct them as carrying charges in the initial year of the purchase. However, this practice is no longer permissible as current tax rulings now permit deductions of only one year's prepaid interest per calendar year. Cash flow, however, can be increased if the developer can arrange an interest-only balloon note which provides for payment of interest alone for up to 5 or 10 years. This allows deferment of principal payments for the given period, but calls for full payment of the entire amount
when the note comes due. Where this is not possible, a low annual constant may be used to reduce the annual payments to an acceptable level. Where the low constant is combined with a "balloon" agreement, the term of the amortizing mortgage will quite often extend beyond the time when the "balloon" payment comes due. This reduces the annual payment, but forces the developer to make a choice between expensive refinancing and an outright sale.

SECOND LIEN FINANCING

A purchase money mortgage may also be used to purchase land already encumbered by a first mortgage. This may be necessary where the first mortgage does not include a prepayment clause allowing the property holder to pay off the existing mortgage through refinancing. Where equity buildup has reached a sizable amount, secondary financing may also be desirable. The primary drawback to secondary financing for land is the lack of adequate security remaining after the first lien is satisfied. In any event, the secondary mortgage must be held to maturity or sold at a sizable discount if the holder is to recover all or part of his original investment.

The reasons a landowner will enter into a secondary position are similar to those given in the case where a first mortgage does not already exist. Risk is greater, however, and there is a danger that the developer will milk the property by
collecting rents in the early operation period of the project and then defaulting. To avoid this, a timetable integrating mortgage payments with other obligations of the property such as water, taxes, and debt on the first mortgage can be arranged. This will give the holder of the second mortgage adequate warning should the developer elect to default. It will also provide for an acceleration of the entire amount of the second mortgage payments should this be necessary.

The purchase money mortgage offers a way for the developer and seller to reach an agreement which makes a sale possible that might otherwise be impossible. The major disadvantages in the technique, is that the contract places an encumbrance on the land which prevents the developer from using the land as collateral for acquiring additional development financing. In most cases, the terms of a second mortgage will be stiff as compared to terms for a first mortgage on the same property.

LAND CONTRACTS

"The land contract, also known as the purchase contract, installment contract, and installment land contract, is simply an agreement to transfer title to land when the conditions of the contract have been met."¹ Although primarily used for the

purchase of undeveloped lots, recent studies have indicated they may have some value as a vehicle for the purchase of developed properties.\(^1\) Their primary attraction is that a sale is possible with a very low downpayment since the title is not initially transferred to the buyer. Land contracts are used primarily where sufficient mortgage funding cannot be obtained for a property and where a developer cannot make the necessary downpayment for the landowner to justify carrying the financing himself.

The typical contract calls for a small downpayment by the developer and, an agreement to pay a fixed monthly installment payment and all tax and insurance cost incurred. The developer is permitted to take possession at once but the title is not passed. Should the developer default, he is subject to eviction and all payments previously made are forfeited.

The land contract allows the landowner to avoid the cumbersome and often extended procedures of foreclosure on the event of default. The additional risk inherent to such an arrangement will also permit him to charge a higher than normal sales price. If provided for in the contract the landowner may further recover his initial investment by mortgaging the land to an-

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other investor and subordinating the land contract. As a last resort he may sell the land contract outright, although probably at a substantial discount.

JOINT VENTURES

One method for an established developer to acquire control of land for development is through a joint venture arrangement with the landowner. Two significant advantages make such an arrangement attractive to the landowner. First, he is able to postpone paying taxes on the appreciated value of the land that would result from an outright sale. Second, he can convert a non-income producing property into an income producing asset.

In return for his contribution to the project the landowner will normally receive equity participation that will probably show him a profit significantly greater than that possible through an outright sale.

GROUND LEASES

Ground leases are used both as ways to acquire control of a property and to finance major development projects. As this is a major financing technique, used both for land and improvements, and is of a creative nature, it is covered in detail under the LEASEHOLD FINANCING section of this work.

CONCLUSION

There are a variety of ways that a developer can maintain or
acquire an adequate land supply for his development projects other than through an outright cash purchase. Major consideration must be given to the impact of cash flow, taxes and types of ownership used to acquire and hold properties. However, above and beyond all legal and economic considerations it must be remembered that location will be the ultimate factor in deciding the degree of success a project will have.
PERMANENT FINANCING

INTRODUCTION

The conventional method of securing the debt financing to implement a development project is by obtaining a permanent first mortgage on both land and building. Using this technique a developer-builder may borrow a high percentage of the funds needed for the project providing him with a debt to equity ratio that permits maximization of leverage benefits.

Mortgages are a traditional form of real estate financing which permit the developer to retain the benefits of ownership while committing his property as security to the mortgage lender. The legal question of who actually holds title to the property during the term of the mortgage will vary depending on the state in which the project is located. Some states operate under the "title theory" of mortgage lending...
which considers the lender as holder of the legal title, while others apply the "lien theory" under which the lender is considered to hold merely a lien against the property. In either case, the purpose is solely to protect the interest of the lender. In some cases, additional security is obtained through use of a note or obligation which makes the property owners personally liable for the outstanding loan amount. Where a default occurs, the lender not only has claim to the property, but also to the personal assets of the borrower for the balance outstanding above the value of the property.

Mortgage funds are used for various purposes including land acquisition, development construction and permanent financing. For identification purposes, they may be classified as related to time or priority. A short-term mortgage is usually granted for five years or less, whereas any mortgage having a term of five years or more would be considered long term. Priority, or position of claim, may be primary as in a first mortgage, or secondary as in a junior mortgage having a second, third, fourth or lesser claim to the security offered.

Some developers will begin seeking debt financing immediately after the land has been tied down, but before title has passed. In many cases, purchase of the land is contingent on obtaining a permanent commitment for the project. Other developers prefer to actually acquire the land before seeking a mortgage commitment.
APPROACHING THE LENDER

Once a developer has determined that a project is feasible and has gained control of a building site, either through acquisition or option, he is ready to approach a lender whose business it is to make long-term amortizing loans on income producing property. At this point, the developer has a choice of approaching a major lender directly or electing to work through a mortgage broker or banker who is familiar with the current money market.

"Getting together the required building plans and making arrangements for mortgage financing can take as little as three months, and as long as six months, depending upon the market conditions, the complexity of the job and the skill of the professionals working on the matter." As time is of the essence, it is extremely tempting to approach several lenders simultaneously. To do so may be all that is required to kill a loan that might otherwise materialize. Lenders spend a great deal of time and money analyzing a project. So if they find a developer is shopping his loan, they may very likely consider further investigation a waste of time and shelve the loan application.

Developers involved in large scale building will normally

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recognize their limited understanding of the money market and prefer to work with a mortgage broker who is better qualified to locate the proper lender and negotiate the best possible terms for a particular project. As such, the mortgage broker becomes an essential link in the land development process. For his involvement, the developer will normally pay a fee of 1 to 1-1/2% of the amount of permanent funds the mortgage lender agrees to advance on completion of the project. This cost may be more than offset by the time saved in negotiating the loan and favorable terms achieved by approaching the right lender with the right deal.

Prime sources of long-term financing include major insurance companies, large commercial banks, savings and loan associations, and real estate investment trust. Regardless of who he decides to approach, the developer will first want to prepare a convincing mortgage package.

PROJECT SUBMITTAL
When an acceptable package has been assembled, including all of the items that a responsible developer would consider, the developer is prepared to submit the mortgage package to a lender along with a loan application that describes precisely what he plans to do and what financing he is seeking.

In most cases the developer will seek about 75% of the total value of the entire project when completed. In most cases
this will be significantly more than 75% of his actual cost. Quite often he can hold his own cash contribution to 10% or less of the actual development cost. To acquire the maximum amount of mortgage money possible, he must convince the lender that the economic analysis he has prepared is fairly accurate.

Large permanent lenders, mortgage brokers, and bankers will normally have experienced staffs that will estimate the costs of a project independently of the developers submittal. Backed by extensive files on cost and expenses, and having the advantage of day-to-day involvement in the business, they are qualified to make a highly accurate financial analysis. It is therefore most important that the developer's submittal be a fair and honest presentation of the project's potential.

**ECONOMIC VALUE**

After checking the building plans, reviewing the market analysis, projected operating cost and income, the lender is ready to determine the size loan the project can carry. It is the economic value, rather than the project cost that determine the extent of financing available for a real estate development venture. It is therefore, important not to confuse project cost and mortgage value. It should be clearly understood that value is not a direct function of cost. As in a corporation, whose borrowing power is inevitably in a direct ratio to its earning power, and primarily independent of physical assets,
it is the ability to repay the debt that is given prime consideration by the lender considering a real estate loan.

It is the capitalization of net income - that is gross income less annual operating expenses and an allowance for vacancies - that determines the economic value of a project. Capitalization is accomplished by dividing the net income of a given project by the current Capitalization or "cap" rate to obtain the economic value of the project. "In its simplest terms, the cap rate is the sum of the interest rate a particular lender expects on the money he lends, plus a lessor amount representing a repayment of the money loaned."^1

Once this economic value has been established, it can then be used by the lender to determine the percentage of the amount he will provide in the form of a permanent loan commitment. In most cases the maximum amount of this loan will not exceed 75% of the economic value.

Cost projections are evaluated, but primarily from the standpoint of confirming that a successful quantitative and qualitative value is being provided for the investment dollar.

In instances where the economic appraisal, made by capitalizing

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PERMANENT FINANCING

the net income, and the physical appraisal, made by evaluating the land and building cost, are both considered, the loan provided is usually set at a maximum of 75% of the lower of these two appraisals.

FINANCIAL STABILITY

Mortgage lenders, due to the speculative nature of their business, are universally conservative, requiring a significant margin of safety based on the financial strength of the developer and the project to be financed. In general, they will try to balance project earnings, cash equity invested and the strength of the guaranteeing signatures of the project owners.

For this reason, the ratio of net income to debt service assumes great importance. For most projects, it is desirable for net income to be between 1.2 and 1.5 times as great as the debt service. In risker projects, an even higher ratio is desirable. Where this ratio is too low, the lenders' solution will be to grant a smaller loan which will result in a lower debt service. As the income remains the same, the ratio will go up. The net income and debt service are the only decision making variables that all lenders can be counted on to use as some lenders will loan a high percentage of a low economic value, whereas others will loan a low percentage of a high economic value.

The financial capability of the equity investors are often evaluated in addition to the projects merits. "Lenders normally
choose not to enter unsound deals even when equity investors are willing to pledge ample collateral to offer a high degree of safety. However, the lenders objections can be met through pledges of liquid collateral, and at some point the importance of the quality of the subject development becomes negligible. In all cases, the developer must be prepared to produce the required equity or collateral when the lender requests him to do so. However, the economic appraisal will be the primary basis for the permanent lender's final decision whether to finance the project or not. "If a permanent lender likes the location, appreciates the tenative design, agrees with the tenative rents and expenses, and has the money at that particular time, it may formally agree to commit its funds on a long-term basis subject to certain conditions including the inspection and approval of the final working drawings prepared by the architect."2

LEASING

If the projects viability depends on long-term tenant obligations the leasing and financial negotiations may proceed together.


The developer therefore will need to know the general terms under which financing will be available. 'While lenders will not issue a meaningful commitment without architectural and financial presentations, mortgage brokers and professional developers who have borrowed many times generally have an idea of the kind of loan they can count on at a particular time, based on the number of cubic feet of construction and the rental potential.' A proven developer can therefore, proceed with the leasing process, realizing that financing may not be available at all unless he can show sufficient leases or very convincing evidence that they will be forthcoming. When the lender can be presented with enough AA-Ai leases to guarantee the mortgage payments indicated as necessary by his own and the developer's income statement, he will then be ready to seriously discuss the possibility of a permanent commitment. If the developer cannot obtain these leases, then a commitment is still possible, but will be based on a much lower loan-to-value ratio that will force the developer to obtain a greater share of his financing from secondary sources.

NEGOTIATIONS

In all cases, the size and condition of the permanent loan will

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be subject to extensive bargaining between the lender and developer. The goals of the lender and borrower are basically different so it is quite possible an agreement will be reached if the money market is not currently too tight. Where money is scarce, the developer will have to make a great deal of concessions, seek out another lender, or postpone the project indefinitely until the economic picture is brighter.

It is not unusual for a developer to be turned down by a permanent lender. The reasons vary and may have little to do with the economic soundness of the project. The number of lending sources available, the idiosyncracies of the individual lenders and the fluctuating nature of mortgage terms make it extremely difficult for someone not involved in the money market on a regular basis to understand or recognize exactly why a lender is not interested.

The lender may feel the project is unsound, is in an area or of an investment type he is not familiar with, or just does not feel the developer is worth taking a risk on. However, most lenders are experienced professionals and have no desire to offend a developer who may bring in a project that is perfectly acceptable to them in the future. As such, they may not say no directly, but may suggest that your timing is incongruent to their current portfolio. Or they might quote terms to stiff to be acceptable, and place the decision of accepting or rejecting on the developer as a delaying tactic.
In other cases they may ask outright that the developer wait a while or make significant revisions in the plans.

In any case, each lender will have a unique way of looking at the project, so what is not acceptable to one may be readily acceptable to another. Unfortunately, there is no way a developer can get a firm quotation of what commitments will be available at some future date.

**THE PERMANENT COMMITMENT**

At the time of commitment, the developer does not actually receive the money for the project from the lender. **Permanent funds are not advanced until the project is completed.** What the developer does receive is a "commitment" from the lender that he will lend the money at some future date if the conditions of the original agreement are fulfilled. The immediate value of this commitment is as a vehicle for acquiring the interim financing required for construction of the project.

The more important terms included in a permanent financing agreement are as follows:

"1) the interest rate; i.e., 9-1/2% plus for example, additional interest in the form of 2% of gross income (a sum approximately equal to an additional quarter to half percent interest).

"2) the term of the mortgage; or the total time allowed to repay the loan.

"3) the amortization period; a loan may be made for a 15 year period with an amortization schedule based on 25 years in which case the borrower makes
annual interest and principal payments as if the loan were a 25 year loan (although the borrower must repay the outstanding loan balance remaining at the end of the 15th year.

"4) the debt service or amount of interest and principal due each year. This is usually a constant amount equal to the first year interest payment plus approximately one percent for a twenty five year loan; and,

"5) prepayment privileges; limiting the rights of the borrower to pay off the loan before the end of the term and specifying any penalties (for example, 3-5% of the loan amount) if the borrower prepays the loan before certain dates."1

CONCLUSION

Once the developer has acquired the permanent commitment, his project is well on its way to becoming a reality. Although some developers who operate on a large scale and have an unimpeachable track record can obtain construction financing without it, most projects cannot proceed until some form of permanent commitment is granted.

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CONSTRUCTION FINANCING

INTRODUCTION
After the developer has obtained a letter of commitment from a permanent lender for the permanent mortgage on the property, he is ready to seek out interim financing for construction of the improvements. In cases where these funds may be obtained without a permanent commitment, the cost of the loan will be higher to reflect the additional risk involved. Prior to seeking construction financing the developer will have finalized the project plans and specifications, and determined whether he will be his own contractor or seek the services of a general contractor to construct his project. The developer will obtain bids from individual subs or an overall bid with an upset price from a qualified general contractor. This is necessary to satisfy the construction lender's desire for an accurate estimate of all construction cost before he will advance any funds.
Interim or construction loans are obtained from short-term lenders such as commercial banks, private lenders, and real estate investment trust who are only interested in lending funds for the construction period prior to the time that the property becomes operational or income producing. Such lenders make construction loans to developers based upon the permanent loan agreement, under the assumption that their investment will be repaid by the funds provided by the permanent lender upon the completion of the project.

GENERAL CHARACTERISTICS

"A construction loan is normally for about 90 percent of the amount of the permanent loan commitment unless the developer has recognized experience and credit."1 Where a "track record" does exist and the developer's credit is sound it is possible to obtain construction funds equal to 100% of the permanent commitment. Funds advanced by the construction lender may be used to pay contractors, subcontractors, professional fees, land cost, property taxes, interest charges and other cost related to the project which are incurred during the construction phase. In many cases a lender will discount the construction loan a few "points" and require that the equity funds of the developer be committed to these expenses prior to advancing

funds from the construction loan. The amount the developer must come up with will normally be the difference between the estimated project cost and the amount of the construction loan. This early investment by the developer is required to assure that the project can be completed without a shortage of funds occurring.

Construction financing works basically as follows:

1) The borrower submits all information and preliminary sketches.

2) Based on this information, a cost analysis and an income and expense projection is made. Matters considered include the location, number of apartments or offices, layout, room size and count, elevators, incinerators, class of construction, etc.

3) A total cost figure is then arrived at by adding the construction estimates to the value of the land or building to be improved. The income and expense of the new or modernized building is estimated, and the property is inspected. From these estimates, the lender decides on the amount of the loan. It may be 60% - 70% of the value of an apartment house or office building, or 50% of the value of a motel or similar business.

4) Upon the borrower's acceptance of the offer, a flexible schedule of payments is mutually agreed upon, a commitment is issued, the title is searched, and a closing of the mortgage is arranged when the building has reached the stage of construction specified in the payment schedule.

5) Subject to an inspection, further advances of funds are made upon notice from the borrower that additional work has been completed.

6) The last payment is usually 5% and is paid
out when the certificate of occupancy is issued and the building is ready for tenants. 1

COST OF CAPITAL

In some cases a developer is said to be capable of getting money at the current so-called prime rate plus and thus receives financing at a significantly reduced interest rate. The actual case is that he usually will be required by the lender to leave a compensating balance of as much as 20% of the loan amount in the bank where he borrows. The result is that his favorable treatment inevitably results in his paying an effective interest rate that closely approximates that of any other developer with a similar track record. Even when the prime rate goes down, the lender will maintain the going overall rate by increasing the percent of compensating balance required for borrowers with access to prime rate considerations.

Lenders may also employ a discount on a loan to achieve the effective rate they are seeking. This has the same effect as a compensating balance, but is achieved by retaining a portion of the loan amount at the outset while charging interest on the total amount requested as the loan. "At any

particular time, lenders will be looking for a certain effective interest rate, and they will get this rate by various methods notwithstanding such artificial limitations as quoted prime rates or statutory limits on interest.\(^1\)

Regardless of the method employed, it is safe to say that the cost of borrowing is a very real cost, often much higher than the stated rate of interest, and one which will have to be borne one way or another by the developer if he hopes to obtain the desired financing. While there are definite advantages to having an established track record, and fund raising will ultimately be an easier task, the cash value of this advantage should not be over emphasized or the actual cost of borrowing overlooked. Of course, in any financial venture the economics of scale will undoubtedly prove of some benefit to those who are capable of operating at a high level of involvement.

CONSTRUCTION

Once the construction financing has been arranged, the developer is ready to proceed with construction. "He makes contractual arrangements with the builder, records the 'loan package'
CONSTRUCTION FINANCING

(short-term, permanent, or standby, if any) all of this through a title company or title lawyer, has an inspection by the bank (the interim lender), and is now ready to commence construction.\(^1\)

If everything goes as planned, the project, after land acquisition, should be self-financing from here on out. By tying the construction loan progress-payments schedule to the needs of the building subcontractors, funds can be advanced at various stages of completion as required. However, this ideal arrangement may be easily upset by any of a number of problems that might arise. "In practice, the failure of one sub to tie together his work with another sub, the bankruptcy or labor problems of one or more subs, slow or late delivery by material suppliers, labor disputes, mechanics liens, weather conditions — and the Good Lord knows what have risen to plague builders since the Israelites left the pyramids."\(^2\)

RISK

The high cost of construction funds is a result of the high degree of risk inherent to this type of financing. Should the developer fail to complete the project it would be necessary for the construction lender to do so if it is to regain

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the funds it has advanced to that time. Although the builder of a project can give the developer a fairly reliable upset price for construction of the project, he cannot be held responsible for conditions that might arise that he cannot foresee. Unknown water below the site, acts of God, and other unknowns may delay or even temporarily stop progress of the construction. The developer too, cannot know the final cost that may result from the possibilities of labor strikes, delays in delivery of essential materials, the length of time required for leasing or similar uncertainties that are an inherent part of the development process. Any one, or combination of these, might be all that it takes to throw the project into a state of economic collapse.

INSPECTIONS
As construction proceeds periodic inspections may be made by the bank, developer, architect, local authorities, and anyone else who has a vested interest in the project. It is their job to see that the general contractor and the various sub-contractors he has contracted with construct the project according to the construction documents upon which the permanent financing is contingent.

LENDER'S OBLIGATION
The construction lender must fulfill all of the conditions set by the permanent lenders if he expects to be repaid his
investment when the project is completed. In addition to providing waivers that guarantee payment of all subcontractors, an income appraisal designating the value of the property, a marketable title to the land, and other legal and technical services that are required to establish the soundness of the permanent lenders investment. The construction lender will also be responsible for seeing that the project is constructed according to the plans and specifications and remains unencumbered by mechanics liens or other obligations.

LENDER'S RETURN
The lender's return on the investment will include interest on the loan amount and a discount. To discount means to make a loan for a specified amount, and then advance only the funds remaining after a number of points (each equal to one percent of the original loan) have been withheld. The borrower is then charged interest on the entire loan amount specified originally, although he receives only the discounted amount. The result is an effective increase in the overall interest. Most lenders will charge the current standard interest rate for the total loan amount and then discount the funds advanced by varying degrees depending on the term of the loan and the amount of risk involved. In many cases, the various fees and discounts charged will equal up to five percent or more of the loan amount over and above the stated interest rate.
HOLDOUT
Although the construction loan is normally sufficient to carry the job to completion, the developer will usually hold back 10 to 20 percent of the construction funds until the project is completed. This gives the developer a degree of control over the general contractor who in turn withholds the funds from the subcontractors. When the job is completed these funds must be forthcoming to make up these payments. In the meantime, the developer can use the funds to help finance the overall cost of the development process. On completion of the job, he must make up this 10 to 20 percent difference either through additional equity capital or funds derived through taking out the permanent loan. "Hopefully, the permanent loan should be large enough to pay off the construction loan, to return to the builder a substantial amount of the equity in his land, and to make enough extra cash to pay the subcontractors any remainders due them on the 10% to 20% holdback."^1

CONCLUSION
Once construction is completed, and the permanent or standby lender is satisfied that the project has been built according to the agreed upon plans and specifications, and all other

conditions of the financing agreement have been met, the
construction lender will be paid off and his involvement
in the development process is concluded.
SPECIAL FINANCING

STANDBY COMMITMENT

When money is tight or lenders are indifferent as to whether or not they get to provide the permanent financing on a project, a standby commitment may be sought by the developer to cope with his financing problems. Similar to a normal permanent commitment, a standby commitment is actually a form of short-term temporary financing which is unique in several ways.

Although considered a viable permanent mortgage against which a construction lender will advance interim financing, neither the standby lender nor the developer have any intention of closing the commitment as a permanent loan when the project is completed. When the time comes for taking out permanent financing, the developer will seek out other sources of financing. "Later, he hopes, the money market will be better,
rents may be higher than expected, and of course, lenders will commit more funds on the completed building.\footnote{Farrell, Paul B., Jr., "The Architect as Developer," \textit{Progressive Architecture}, May, 1970, 92.}

There are definite advantages to waiting until the project is completed before obtaining the permanent financing. If the money market is favorable, the project may merit a significantly larger loan at a slightly lower interest rate. This is possible because there are many more permanent lenders willing to commit mortgages on existing buildings than there are available to commit for buildings not yet built. There is a great deal less risk in mortgaging a completed project than obligating funds secured only by an unimproved site, proposed plans, and the developer's potential to complete a project. A developer with a completed project is not under the pressure to immediately obtain permanent financing as one on the verge of starting construction. He may therefore pick and choose both lender and terms and will not be pressured into making unwise or uneconomical decisions.

To assure that the developer does not close or "take down" the standby loan, the lender will set the interest rate purposely high and the loan term short. Although the developer recognizes the terms are unrealistic, and that a fee must be paid to the
lender on acceptance, he will nevertheless accept the commitment to be used as a vehicle for obtaining construction financing. In some cases, it is the standby lender who will advance the interim construction funds for the project.

Should the developer fail to achieve more favorable financing, he may actually elect to take out the standby loan, realizing that it is only a temporary solution to his problem. This is possible because a standby commitment, unlike a normal permanent commitment, does not call for the developer to be "locked in" or prevented from prepaying the loan for an extensive period of ten years or more.

After a project is a proven income producer, or rents have gone up due to inflation or increased demand, and the property has a higher economic value, the developer can refinance the project under a larger mortgage and pay off the standby lender.

"And since a developer normally takes the risk of leasing up the project anyway, the more sophisticated ones are using standby commitments as short-term financing techniques and then going for the permanent financing later at the completion of the project when they feel confident that they can obtain a better loan."1

SPECIAL FINANCING

The standby commitment has a variety of other uses also. When a developer feels he can obtain higher rents than other existing projects in an area, and thus deserves a larger than normal mortgage, he can use a standby commitment until he has proven his point. Where ownership is fragmented as in a condominium project, where construction lenders will normally not accept permanent loan commitments to the various individuals as sufficient security to advance funds on, a standby commitment may also be necessary.

GAP FINANCING

As the economic value of a development is based on the rents from the completed project, it is not uncommon for the permanent lender to condition the loan on the achievement of at least 80% of these rents. That is, until the agreed upon occupancy level is reached, the lender may "hold back" 15% to 20% of the permanent loan commitment. The holdback will usually remain in effect until the project can create enough cash to pay all operating expenses and the monthly debt service on the mortgage.

The amount of funds the permanent lender will advance prior to fulfillment of the required occupancy ratio is known as the "floor" amount of the permanent loan. The total amount of funds committed through the permanent loan is called the ceiling "amount." The difference between these two is called the "gap."
As a construction lender will advance the interim financing only equal to the floor amount of the permanent loan, it is necessary for the developer to either come up with additional equity money or to find a lender who will provide a "gap" commitment for the remaining percentage not yet available. He must do so to have sufficient funds to complete the construction should construction advance faster than the renting.

Gap financing may be accomplished by obtaining a standby or gap commitment through a second mortgage from a separate lender at a higher interest rate and shorter term, or from the permanent lender through paying of an additional fee.

When the permanent loan is closed, the standby will provide a second mortgage for a term sufficient to allow the developer to achieve the rent roles required by the permanent commitment. Should the developer fail to satisfy the quota in the specified time he may have to sell, refinance, or obtain funds from other sources to pay off this second mortgage.

The standby lender does not actually advance the funds, but merely agrees to "stand by" to take up the gap if the occupancy level required by the permanent lender is not achieved. This additional commitment and the floor amount of the original permanent loan commitment will then equal the full amount of the permanent commitment providing sufficient guarantee for the interim lender to advance the "ceiling" amount of the
permanent loan as construction progresses.

The standby loan will have a significantly higher interest rate than the permanent loan, primarily because it will only be disbursed if the project is doing poorly and rents are going slowly. If the project is going well, it will not be necessary to use the standby funds. In either case, the standby lender has only the credit rating of the developer as security for his commitment. As such, the companies who make standby loans will receive interest several percent higher than that on conventional loans. If the loan is not taken out their fee will come from the fees received at the time the commitment was issued. In most cases, such companies make money by issuing commitments for loans they will never be called upon to issue.

A standby commitment should be written in clear and simple language which ties it to acceptance and closing of the permanent loan. Thereby, if the completed building is acceptable to the permanent lender, it will also be acceptable to the standby lender.

COMBINED LOANS

Lenders will sometimes offer to combine the interim and permanent loan into one package for financing the development of an economically attractive project. They will advance all construction funds while the project is being built, and on completion, also make the permanent loan. The incentive for
doing this is threefold. By providing a package loan, the lender is assured of getting the permanent loan that is the primary source of his profit. The lender can also maintain control of the building inspection during construction and is thus assured the project will be built properly and according to the plans and specifications agreed upon. Finally, the overall rate charged for the permanent loan can be justifiably higher due to the extra risk incurred through participation in the construction loan.

A loan package is beneficial to the developer in that it allows him to make all of his financing arrangements in one place, thus eliminating problems of dealing with more than one lender. Financial carrying costs, service fees, and discount points charged will also most likely be reduced.

The combined loan is especially attractive to developers who build for resale and wants to use the installment method of reporting his sale. To avoid receiving more than the maximum 30% of the sales price in the first year a developer may take the construction loan in the form of a mortgage on the property. Since an existing mortgage assumed by the buyer is not included in the 30% payment, if it does not exceed the seller's basis, the buyer must pay only the difference between the construction loan and the permanent financing. He can therefore make a first year investment payment somewhat lower than 30% of the total purchase price.
PRE-CLOSED LOANS

One way of assuring that the lender who makes the permanent commitment will also provide the permanent financing is by the use of a pre-closed loan. When interest rates are high, it is the permanent lender, seeking to guarantee that the borrower will take out the permanent loan, that initiates this type agreement. When interest rates are low, it is the borrower who will benefit from assurance that the permanent financing will be forthcoming when needed, and not withheld on a legal technicality claimed by the lender.

Two variations of the pre-closing agreement are currently in use. A Purchase and Sale agreement is a contract between the interim lender, the permanent lender and the borrower that spells out the conditions which must be met if the permanent financing defined in the permanent commitment is to be provided on completion of the project. The contract for the project is purchased and a lien assigned to the permanent lender which is legally recorded to bind all parties to the conditions stated therein.

An alternate method of pre-closing the permanent financing, is through the use of a Tri-party Agreement between the interim lender, the permanent lender, and the borrower. This contract guarantees that the issuer of the permanent commitment will be the one to provide the permanent financing required to retire the construction loan.
In addition to the assurance that permanent financing will be provided as defined by the permanent commitment, the pre-closed loan offers many of the advantages provided by a combined loan. Negotiations, fees and time of implementation are greatly reduced and the uncertainty of future financial arrangements virtually eliminated. The primary disadvantage is that a significant amount of flexibility in future negotiations is lost to both lender and borrower.
SECTION THREE: CREATIVE FINANCING TECHNIQUES
CREATIVE TECHNIQUES

There are numerous individual and combinations of creative financing techniques that may be employed for the financing and refinancing of major real estate development projects.

In general they divide into two basic categories:

(1) Those that provide equity ownership participation to the lender.

(2) Those that provide cash flow or income participation to the lender.

Creative financing techniques that emphasize equity participation or ownership as the primary source of return to the lender-investor include:

(1) Joint Venture "Front Money" Deal

(2) Sale and Leaseback

(3) Sale and Leaseback and Leasehold Mortgage

(4) Sale and Buyback

Techniques that emphasize income participation as the primary
source of return to the lender-investor include:

(1) Contingent Interest
(2) Variable Rate Mortgage
(3) Wraparound Mortgage

There are also a number of methods that may be used to achieve acceptable financing for situations that are exceptions to the norm in real estate development projects. Although not actually creative financing techniques themselves, these lending methods become vehicles for the application of creative financing techniques. Among the more common these are:

(1) Basket Clause Loans
(2) Stock Ownership and Options
(3) Bondable Net Lease
(4) Lenders Joint Pool Financing
(5) Divided Amortization Schedule
(6) Piggyback Loans
(7) Balloon Loans
(8) Annual Constant

In many cases a combination of creative financing techniques will be employed concurrently and the lender will thereby receive the benefits of both equity and income participation.

Other creative techniques undoubtedly exist today or will come into being in the near future. However, a majority of the techniques currently in use are presented here. Others, where
they may exist, though specifically different in detail, will nevertheless be based on the same creative vein from which these techniques have emerged. Regardless of methodology, what becomes apparent is the basic underlying business principle that the only truly good business deals are those from which every party involved stands to gain. Where this premise does not hold true, at least in the realm of creative financing, the means becomes the end, and the very creativeness on which the process is based will cease to exist.

This final section deals with identifying and analyzing the various creative financing techniques currently in use. To facilitate this analysis major techniques are examined under the following format:

(A) BASIC CONCEPT
(B) GENERAL CHARACTERISTICS
(C) LENDER IMPACT
(D) DEVELOPER IMPACT

Where considered beneficial for further clarification of a technique, examples and cash flow analysis are also provided.

A great portion of the creative financing techniques currently in use employ some form of "leasehold" financing as the basis for their existence. To properly comprehend these more sophisticated financial arrangements it is first necessary to understand the basic concept and characteristics of this highly versatile financing tool. Although a creative technique in
its own right, its major significance is achieved through use as a building block for more complex financial applications.
LEASEHOLD FINANCING

BASIC CONCEPT

"Leasehold mortgage financing is a special form of secondary financing in which the builder or developer enters into a lease with the property owner and then gets a mortgage on the leasehold." It is primarily used when the price of an urban property is unusually high or simply not for sale.

In some cases, especially in the central business districts of cities where land has undergone rapid appreciation, the taxes resulting from a land sale, even at capital gain rates, will be so high as to make an outright sale an unprofitable undertaking for the owner. In other situations, the price of

a property will be so high that the potential developer cannot obtain a mortgage for the proposed project sufficient to adequately absorb the excessive land cost incurred.

Regardless of the reason, where land cannot be purchased, a leasehold on the property may offer a suitable alternative. By obtaining a long-term "ground" lease, and arranging for a leasehold mortgage using the leasehold as security, a developer may thus be able to acquire control of desirable urban property that might otherwise go undeveloped. Whether such an arrangement is feasible depends on whether the landowner is willing to accept the lease on the land as a long time investment in lieu of the lump sum he would receive from an outright sale and whether or not the developer feels a lease, rather than ownership, will suffice to accomplish his goals.

GENERAL CHARACTERISTICS

A "ground" lease may provide for the landowner's fee to be subordinated to the claims of the leaseholder and the leasehold mortgagee. This factor is extremely important as it will ultimately determine the financing value of the leasehold position to the developer.

To be mortgaged, the leasehold must have an independent value resulting from an operating income that exceeds the required ground rent. A lender will therefore want to verify the existence of such an income, be sure that ground rents are not
excessive for both current and renewable terms, and that the occupancy tenants are paying adequate rental to meet the required debt service of the leasehold mortgage. The length of tenant leases, credit ratings of occupants and clauses providing for subordinating the ground lease must also be considered.

If these items are acceptable, a loan may be made on the leasehold of a size somewhat less and having an interest rate somewhat higher than that which would be generated by a mortgage loan on the same property. Maturity for the loan will be limited to the unexpired term of the "ground" lease so as to be fully amortized within that period.

Although the term of the lease need only be equal to that of the loan, lenders prefer as great a "cushion" time between the lease and mortgage terms as possible. Governing Statutes often prohibit institutional lenders from making leasehold mortgages for longer than the initial lease term. Often there is also a minimum length the initial term may be given if an option to renew the lease is provided. Thus, statutory restrictions prevent a national commercial bank from entering into a leasehold arrangement with a leasehold that will expire in less than ten years after the date the loan matures. Similarly, a federal savings and loan association is restricted to requiring a minimum of fifteen years as a cushion.

The conditions of the current money market will usually determine
LEASEHOLD FINANCING

...to what degree a lender is willing to provide financing of an unsubordinated lease. In cases where the landowner will not subordinate his fee to the mortgage lender, the leasehold becomes the sole security for the project. Both the lessor's rent claim and the rights of the fee mortgagee will therefore have claims ahead of the leasehold mortgagee.

The landowner may be justified in his reluctance to subordinate his fee. Such action may greatly reduce the value of the property to him as he must relinquish his right to mortgage the land himself, and also expose himself to the great risk inherent to possible foreclosure. By subordinating his fee, he actually places the leasehold mortgagee in a position similar to that of a fee mortgagee.

Nevertheless, the lender will prefer that the current and any future fee mortgage be subordinated to both the lease and the leasehold mortgage. Where such subordination cannot be obtained, it is quite possible that acceptable project financing may actually be unattainable. Some lenders feel they cannot, or will not, make a loan in a situation where their position would be that of a secondary lien holder. Such caution on the part of the lender may be justified when the increased risk and reduced security offered by an unsubordinated ground lease are considered.

In most cases, due to the greater risk involved, the loan-to-
LEASEHOLD FINANCING

value ratio of the loan will be somewhat lower than that available for a fee mortgage. The result is a loan somewhat lower than the value of the improved land, but often sufficient to accommodate most of the developer's cost.

LENDER IMPACT

"Since the mortgagee must be sure it can act for the lessee if he defaults under the lease, the mortgage will provide that a lease default also constitutes a default under the mortgage." This reduces the lender's risk by making a recovery of the loan more certain in the event of financial difficulties for the developer. Where renewal options exist, the lender will require the right to acquire them on the event of default by the developer. The lender may also require that these renewals be exercised immediately or within a few years after the loan is granted.

If the lender should have to take over the property he will be obligated to pay the ground rent. Should the developer default on his lease payments, a forfeiture of the lease might result, thus obliterating the lender's only security. At best, the lender's security is lower than that of a fee mortgagee, as it is secured by the improvements alone, not by the land.

Interest rates will therefore be higher and the mortgage term

will most likely be tied directly to the tenant's lease terms. The loan-to-value ratio will also be set at a lower percentage.

One way of protecting the lender's interest would be to require the leaseholder to prepay a portion or even the entire amount of the ground rental for the mortgage term. However, this would usually be unacceptable to both the landowner and the developer, as the developer would have to put up a large sum of cash at the outset and on receipt of the sum the landowner would have to immediately pay the taxes incurred.

If the leasehold mortgage is related to only a portion of the property leased, the lender might request that a comparable portion of the ground rent be prorated to that portion. Such an arrangement would allow the lender to pay ground rent only on that segment of the property, rather than on the entire lease, should it be necessary to do so to protect its security in the event of a default. As further protection, the lender may request early notice of any default and a sufficient time period beyond that allocated for corrective action by the developer, so he may cure the default himself, should the developer fail to do so.

The lender will also want to avoid provisions that provide for automatic default. Should the developer declare bankruptcy or undergo a reorganization, the lender will want the right to renew the lease himself on the same terms as the original con-
tract. Should the developer abandon the lease outright, or
instigate any other noncurable default, the lender should also
have access to a new and equal lease. Basically, what the
lender is seeking is a degree of control over any contingency
that might arise, whether curable or not, that might eradicate
the lease which serves as sole security for his investment.

As it is the improvements on the leasehold that generates the
income to pay the ground rent, the land owner will normally
require that all insurance funds resulting from damage or destruc-
tion of the property be applied to restoration of the same. In
cases where the developer may prefer to give the insurance pro-
cceeds directly to the landowner in lieu of doing restoration,
the lender would undoubtedly object, as doing so would negate
the reinstatement of security for its investment. Thus, the
lender will usually prefer that insurance reimbursements be
assigned to him so he may pay them out directly to the contrac-
tor as the restoration work progresses. Should funds remain
in excess of repair cost, negotiation will have to take place
to determine whether they will be applied toward reducing the
outstanding balance on the leasehold mortgage or merely returned
to the developer for his personal use.

If all or a portion of the property is condemned, the lender
will be primarily concerned with seeing that the outstanding
loan amount is reduced by a proportionate amount to that of
the leasehold's income reduction. The developer will, of
course, want his share of the condemnation proceeds to be equal to the cost of his improvements. As such, the lender's interest is also protected. However, problems may arise where land values have risen very rapidly and to a point where the landowner's share of the proceeds diminishes the portion remaining for the improvements.

The lender's concern is for full payment of the mortgage debt in the event of a partial taking that will terminate the lease. He will also seek the capitalized value of any rent lost due to a partial taking. Where excess funds exist, he will want them to be used to reduce the mortgage or restore the premises if possible. If a partial taking occurs, but does not abate the rent, he will want the entire condemnation award to go toward reducing the mortgage.

Should damage without an actual taking occur, as with the loss of access, the problems and disbursement of awards will be similar to those where a partial taking does occur.

It is important to the lender, and any subsequent owners, that liabilities incurred before actual ownership by them takes place, be completely averted, as such conditions may adversely affect the market value of the lease. On the other hand, if the developer has an option to purchase, the lender will inevitably want the mortgage debt to be an encumbrance on both the lease and such options.
LEASEHOLD FINANCING

The landowner will usually require that in the event of default on the ground lease, subleases will continue between himself and the subtenants. The lender, in turn will want the landowner to agree to assign these to him under a new lease if a default by the developer takes place. As a final means of protecting his investment in the leasehold, the lender will want to prohibit both the landowner and the developer from instigating amendments to the ground lease without first obtaining the lender's approval.

DEVELOPER IMPACT

In addition to the right to subordinate the fee to a construction loan, permanent loan, or a refinancing loan, the developer will want the right to subordinate different portions of the ground to different mortgages. If the landowner is reluctant to subordinate to future refinancing, out of fear that the developer may try to milk the property over a short period through excessive mortgages, it may be necessary to include a provision in the lease that specifies how refinancing funds are to be spent.

To assure that the lease is a saleable product, it is important that the developer be unrestricted in his right to assign or sublet the property. The lender may require that this right also be extended to him, should a default occur.

For convenience of execution in all transactions, the developer
may require the right to act as the landowner's attorney-in-fact for negotiations and consummation of all financial agreements. He may further request that the ground lease contain a clause requiring the landowner to execute, immediately and on presentation, necessary legal documents as submitted to him. To avoid personal liability required by the lender, the landowner may have to convey title to the land to a corporation having the power to execute the necessary transactions and then reconvey the land back to the landowner. To further protect himself and his interest, the landowner may want an opportunity to cure any default that might occur toward the leasehold mortgage, and the authority to include expenses incurred in doing so under the developer's rent obligation.

The lender and the developer-borrower will ultimately benefit if the landowner agrees to subordinate his fee and thus allow the land to serve as additional security for a loan. "If the 'ground lease' (rent to be paid on the land) is reasonable and the owner agrees to 'subordinate' his interest in the land to the lender holding the mortgage in the improvements (that is give the lender the right to sell the building and land if there is a default on the mortgage payments) then a developer can obtain a loan based on the economic value of the building and land without having to invest any capital in the land."

The result may be a loan of sufficient size to cover the developer's total cost of land and development.

Since the lender has the land and improvements as security to justify a larger loan than otherwise possible, the developer may then be able to provide a more extensive improvement that will provide a higher income for him while indirectly benefitting the landowner through increased security. The landowner may also receive some direct benefit in the form of additional income if the lease ties the amount of ground rent directly to the lessee's income. Should the developer anticipate refinancing the leasehold at some future date, the landowner may receive additional benefits through participation in the profits accrued in exchange for allowing subordination of his fee under the new mortgage term.

A leasing arrangement also enhances the tax position of the developer. Under a ground lease, the periodic rental payments are fully deductible for tax purposes, whereas under an outright purchase, only the interest portion of the payments would be deductible. Thus, land cost, which are not normally a deductible or depreciable item, become a tax shelter for other income.

If the landowner should choose not to subordinate his interest in the land, but the ground rent is reasonable, it may be necessary for the developer to secure leasing commitments for a designated portion of the leaseable area before a permanent
mortgage can be obtained on the improvements alone. Even after doing so, the developer may find that the lender will require the mortgage to be tied to the tenant's lease terms. Interest cost and fees will undoubtedly be higher also. The landowner may be convinced to subordinate if he can be made to realize that he would have to put up the land for security anyway, if he were to develop the land himself. The possibility for higher rental from subordinated land may also serve to influence his decision.

Whether subordinated or not, a lease causes the landowner to provide partial financing for the land. The developer need raise only the funds required to construct the improvements and pay the annual ground rent to make the project both viable and profitable.
JOINT VENTURE "FRONT MONEY" DEAL

**BASIC CONCEPT**

In a Joint Venture "Front Money" Deal the lending institution normally provides 100% of the necessary cash investment in a project, while the developer supplies the land or an option on the land and the entrepreneurial skills necessary to implement the required construction, leasing and management for the project. Whether such an arrangement constitutes a creative financing technique or merely a unique form of ownership is not important. What is relevant is the impact it is having on the construction industry.

"With the end of the tight money period we can now see more clearly which of the modern real estate financing techniques are likely to survive because they fill a genuine and relatively permanent need of the economy. The joint venture in which the
investor pays his way and takes the equity risk (described above as the joint venture 'front money' deal) will seemingly endure. It is not founded on emergent temporary necessities of the developer, but in the perennial problems of real estate financing which will become more acute as projects increase in size, cost and complexity.\(^1\)

**GENERAL CHARACTERISTICS**

Normally conducted under a subsidiary organization of the lender and developer to limit liability, the Joint Venture may be in the form of a general partnership, limited partnership or a corporation. Division of ownership and profits is negotiated. In most cases, the developer will own or have an option on the land to be developed. After doing the preliminary work, he will approach the investor with a deal that permits him to contribute the land and advance effort at its current value rather than his actual cost.

The developer may sell half of his package to the investor in order to obtain the necessary front money or the lender may supply all of the cash. If the former occurs, the profit will probably be split fifty-fifty. When the cost basis of the land is low, the developer should exchange it for interest

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in the joint venture rather than sell it and have to pay capital gains taxes. In the latter instance, the lender will undoubtedly insist that all of his money be returned with a suitable interest before any split of net income takes place. While such repayment is in progress, the developer may receive income from fees paid for constructing and managing the project.

LENDER IMPACT
The lender receives the normal benefits of interest plus a "kicker" giving him an opportunity to participate in the profits of the project. In addition, the participating lender may receive an option to provide the interim and permanent financing for the project at the current market yield.

As the lender is risking loss of his investment without obligating the owner-developer, there is no usury question involved. A major legal conflict does occur, however, over the question of who should hold the title to the project. In most cases, it is desirable to rest the title with the joint subsidiary. Thus, the lender's principal assets are protected against liability, the lender may remain anonymous, and price hiking due to association with a major institution can be avoided.

DEVELOPER IMPACT
This technique makes it possible for the developer to acquire the capital he needs to carry out one or more projects
simultaneously using maximum leverage and with a minimum of risk. Equally important is the ability to benefit from initial losses and accelerated depreciation that help to offset his personal income taxes. A Joint Venture "Front Money" Deal also allows him to maximize the potential of the entrepreneurial abilities that make him unique from other participants in the real estate development market.

EXAMPLE

To demonstrate the use of the Joint Venture "Front Money" Deal, the example of the Urban Office Building can be analyzed.

After acquiring the land and organizing the project, the developer approaches an institutional lender with a joint venture proposal. In return for 100% financing of the development cost, the developer and lender agree to enter into a limited partnership arrangement whereby each will own one-half of the completed project.

As the land contributed by the developer has a value of $250,000 the development cost will equal the project budget less this amount or $8,950,000.

Project financing will be provided as follows:

Lender - 100% development cost $8,950,000
Developer - Land cost 250,000
Total Budget $9,200,000

The feasibility study revealed the project to have an economic
value of $10,000,000 and a net income of $1,000,000 per year.

The net income will be split in the following manner:

- Lender takes 8% of $8,950,000  $ 716,000
- Developer takes 8% of $250,000  20,000
- Lender and developer split 50-50  264,000
- Total Net Income  $1,000,000

- Lender's total annual return  $ 848,000
- Developer's total annual return  $1,000,000
- Developer's cash rate of return  60.8%

A comparison of the return on investment using the joint venture arrangement and the return on the conventional permanent mortgage arrangement analyzed previously gives a clear indication of the impact of leverage. Although the developer now owns only 50% of the project, his annual cash rate of return has more than tripled and the total rate of return is more than five times that of the conventional arrangement. Although the after tax cash flow is nearly one-half of the conventional arrangement, the equity requirement is now less than one-sixth of that required by the conventional method of financing.
SALE AND LEASEBACK

BASIC CONCEPT

The sale and leaseback technique is one of the oldest creative financing techniques in existence. The traditional application is for the developer to sell his property to a lender who in turn will lease it back to him. More recent creative applications include sale and leaseback of both land and improvements on a property and sale and leaseback of only the energy system of a project. "Utilizing the sale leaseback to provide for additional investor compensation by way of participation in income as well as its application to other than fee estates, is a fairly recent innovation."¹

GENERAL CHARACTERISTICS

In a land sale-leaseback agreement, the developer sells his property to a lender who then leases it back to him under a long-term lease. The developer then uses the money acquired from the sale to build improvements on the land sufficient to cover the cost of the ground lease payments.

Terms vary considerably depending on the lender's participating in the current market for such projects. A typical property might be bought for 100% of its appraised value and then leased for 30 to 40 years with two or more renewal options of ten years. The annual lease rate normally varies between 9 and 10 percent of the original sales price of the land.

In a sale-leaseback/100% financing arrangement the lender purchases both land and improvements and thus provides virtually 100% financing for the project. This usually occurs when depreciation on the property has been reduced to a point below that required to shelter the income derived from further amortization of the property. The terms of a total purchase agreement will vary with the quality of the project and the strength of the tenants and their lease contracts. "It is important that the lessee's position be a sound one, for this represents the 'cushion' for the safety margin above the investor's position."

SALE AND LEASEBACK

A sale under this arrangement, normally contingent on achieving predetermined rental levels for the project, can be arranged before or after development takes place.

In a sale-leaseback of energy system, the total energy system of a project is purchased by a lender who is willing to subordinate his interest to that of the first mortgage lender. This technique allows the developer to recapture a significant portion of his total project development cost.

LENDER IMPACT

The lender benefits through the land sale-leaseback arrangement by securing an ownership position in a property where the ground lease value is relatively assured by the improvements built on it. "The higher the value of the improvement the more secure would be the fee position. In practice, the leasehold value should exceed the value of the land by at least 1-1/2 times so there would be adequate security for the fee purchaser." 1

What the lender receives is a nonsubordinated fee position offering an attractive yield on a lease having an initial term for as long as 40 years.

The lender-investor in a sale-leaseback/100% financing arrange-

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ment will be sole owner of a property with a proven record of earnings. He also receives a contingent return should the property appreciate in value plus the leverage possibilities inherent to mortgaging of the fee.

The lender in a sale-leaseback of energy system arrangement normally assumes responsibility for maintenance of the system. He then leases the system back or actually sells power for use as required by the improvements.

As lender requirements will vary, careful considerations must be given to the overall economic impact of any type of sale and leaseback arrangement. Some lenders will seek high yields and long-term leaseholds, but be difficult about repurchase options. Others will accept low yields in order to demand short-terms sufficient to greatly restrict additional financial opportunities.

Whether the return to the investor in a sale-leaseback arrangement constitutes a violation of the usury statutes, may depend on whether the contract provides for eventual repurchase of the property by the developer. If this option is not provided, the equivalent of interest achieved through high rent payments on the ground lease may not be considered as interest on a debt. If so, the usury regulation in question may not be considered exceeded.

Where the repurchase agreement does exist, the transaction may
be looked upon by the courts as a loan. In most cases, the repurchase is optional rather than mandatory. "Whether or not a court regards the entire transaction as a loan depends on whether the parties actually intended the financing device as a loan."¹ This intent may be determined based on the resale price of the project in relation to its value and the economic considerations that determine whether the repurchase option will be exercised or not.

If the property value greatly exceeds the sales price stipulated, it is obvious that the developer would indeed repurchase the property. Thus, the transaction might be considered by the courts as merely a loan for which the property title was conveyed as security during the term of the lease. Where economically logical, options are available to the developer, such as the right to extend his lease or repurchase the land at a fair appraisal value, it is quite possible the transaction would be considered a genuine sale and leaseback. As such, a usury violation would not exist.

The question of usury usually arises where the developer is seeking a way out of his contract with the lending institution. However, the decision that the agreement is in actuality a

loan rather than a sale-leaseback may have grave tax consequences to all parties involved. If determined a loan, the developer stands to lose the deduction privileges for the amount of rental payments considered in excess of normal interest and amortization payments on a mortgage repayment on the same property. In turn, the lender will lose the right to terminate the lease on default by the developer. Instead, he must undergo the difficult and often time consuming involvement of a mortgage foreclosure. In some states this is greatly complicated by the existence of extended redemption periods.

DEVELOPER IMPACT

In a land sale-leaseback arrangement the developer receives a purchase price of 100% of the appraised value of the property and the right to acquire a leasehold mortgage using the leasehold as security. The agreement will be conditioned on the understanding that the developer will erect an improvement on the land at a cost in excess of the land value. It is important to both the developer and lender that the land be purchased at a fair market value. If the price is excessive, difficulties will arise in negotiating the condemnation clause between the lender as fee holder and the leasehold mortgagee.

In a sale-leaseback/100% financing arrangement a developer with an established record of successful projects may obtain 100% financing by selling the land and buildings and leasing them
back. The developer then assumes the role of a building operator who manages the project and serves as leasing agent to project tenants. This arrangement is attractive to him because it allows him to retain operational control through the leaseback while removing the economic burden of taxes resulting from increased amortization and a depleted depreciation base. The profits from the project continue and the lease payments are fully deductible.

When the developer sells the land he gives up the right to long-term appreciation of the property except that which he may recapture by exercising existing repurchase options. "But at the same time he has reduced his equity investment, substantially furthering his goal of leveraging a small equity position (the major attraction of real estate investment) and increasing his tax shelter."¹

The sale-leaseback of energy system arrangement allows the developer to draw off a sizable sum of his equity investment from the project. "In a typical installation, the developer's future cash flow is not affected by any increase in charges for energy purchased, yet he is able to recapture 10% to 15% of his total project cost, thereby substantially reducing his

SALE AND LEASEBACK

equity investment."

EXAMPLE

The benefits of the sale-leaseback/100% financing arrangement can be demonstrated by analyzing the Urban Office Building project.

The land and improvements for the project can be sold to an institutional lender for an amount equal to the total project budget. The lender will then lease the project back to the developer for an annual rental amount equal to 9% of the purchase price.

Project financing will be provided as follows:

| Lender - 100% development cost (including land) | $9,200,000 |
| Developer - none | -0- |
| Total Budget | $9,200,000 |

Income from the project would be distributed as follows:

| Net Income | $1,000,000 |
| Rental Payments | 828,000 |
| Cash Flow Before Taxes | $172,000 |

Although the developer cannot claim depreciation once he has sold the project, he may still deduct the rental payments and thus maintain his after tax cash flow at a reasonable level. This arrangement allows him 100% funding for the development of the project thus permitting him to develop a project that provides a sizable cash return without any cash equity requirement on his own part.
LAND SALE AND LEASEBACK AND LEASEHOLD MORTGAGE

BASIC CONCEPT

This method of separating the fee and improvements includes a sale-leaseback of the land under the building and a subsequent mortgaging of the leasehold rights. By financing the values of the property separately, the developer is able to use the full value of the land as capital in addition to the mortgage value of the leasehold which may represent as much as 75 percent of the cost of the improvements.

GENERAL CHARACTERISTICS

In some cases an institutional lender will agree to finance both the acquisition of the land and the construction cost of the improvements. To make a project feasible, the lender will purchase the land from the original landowner at a price previously agreed to by the developer and landowner, and then
lease the land over a long term to the developer who initiated the purchase. For providing the front money, the lender will usually demand a significant portion of the cash flow earned by the improvement in addition to a reasonable return on its investment through the ground lease rental payments. Terms of the lease usually provide for repurchase of the land after a designated period of time for a predetermined appreciated value. Refinancing after a limited "lock in" period is also provided for.

The amount of participation by the lender may be determined by a downward sliding scale based on the duration of the lease prior to exercising of the repurchase option. With each year's extension of the lease after the initial year of the repurchase option, the lender's share of income participation is reduced by an incremental amount. Thus the developer, with little or no personal investment, owns the leasehold interest on the land where a major improvement will be built, owns the improvements, benefits from depreciation deductions on the improvements, receives a sizable portion of the income from the property, and in some cases receives a management fee for operating the property. He may also have the option to refinance the property and eventually buy out the lender's right to participation with his share of the refinancing proceeds.

The lender, in turn, has a quality tenant and favorable lease terms, and is relatively certain of receiving regular ground
lease payments and interest and principal under the mortgage it holds. However, the real profit to the lender will more than likely come from the high ratio of income participation he receives from the improvements.

LENDER IMPACT

To compensate for the greater risk incurred through commitment of such a large share of the capital for the project, the lender will expect a higher than normal yield on his investment. This return will be derived primarily through equity participation in the project. In addition to the potential gain through appreciation of the property the lender will undoubtedly seek a portion of the profits resulting from the improvements. The question of usury, as in all sale-leaseback arrangements, will always be prevalent in an arrangement such as this.

DEVELOPER IMPACT

This arrangement is acceptable to the developer as he is able to obtain significantly more capital for his project than would otherwise be possible. He also retains the tax shelter of both the depreciation deductions on the improvements and rental payments on the ground lease which can be fully deducted. Cash flow for the project is thus greatly improved.

"The ground rent plus debt service on the leasehold mortgage (in the case of improved property with the building severed
LAND SALE AND LEASEBACK AND LEASEHOLD MORTGAGE

and retained by the lessee) will exceed the debt service on a straight mortgage of land and building. The reduction in equity requirements through sale of the land and the increased tax shelter combine to provide a tax flow in excess of that obtained through a straight mortgage on the land and improvements combined. As the leasehold provides the security for the investment by the lender, the developer will normally have very little or no personal liability for the project.

EXAMPLE

The benefits of a land sale and leaseback and leasehold mortgage arrangement can be demonstrated by an analysis of the urban office building project.

The $250,000 land cost capitalized at a rate of 10% determines an economic value of $2,500,000. At this price, the land can be sold to an institutional lender and leased back at a ground rent of 9% per year or $225,000. Net income after payment of the ground rent comes to $775,000. This amount can then be capitalized at 10% to arrive at a leasehold value of $7,750,000.

A 75% leasehold loan will then be made equal to $5,812,500 having an interest rate of 8% and an annual constant of 10%. Debt service on the improvements will thus be $581,500 per year.

Total debt service on land and building will equal $806,250.

Financing for the development of the project would be provided as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage on Land</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Mortgage on Improvements</td>
<td>$5,812,500</td>
</tr>
<tr>
<td>Total Debt Financing</td>
<td>$8,312,500</td>
</tr>
<tr>
<td>Required Equity</td>
<td>887,500</td>
</tr>
<tr>
<td>Total Project Budget</td>
<td>$9,200,000</td>
</tr>
</tbody>
</table>

Using this arrangement the developer's equity requirements are reduced to one-half of that required using the conventional first mortgage financing analyzed in the feasibility study. However, his cash flow before taxes is almost 60% of that provided using the prior method and he still retains the full benefits of depreciation of the improvements. In addition, he receives deductions for the rental payments made on the ground lease. Cash flow and tax shelter are thus significantly greater than that obtained through a straight mortgage on the land and building.
SALE-BUYBACK

BASIC CONCEPT

A sale-buyback agreement is one in which the lending institution purchases the property in question for a mutually agreed upon price, usually between 80 and 90 percent of the economic value and 100 percent of the developer's cost of land and improvements, and then contracts to resell the property back to the developer for the same amount through use of an installment sale contract over a specified number of years. "The lender retains title to the property, but the developer also retains an equitable interest in the title, and this feature enables him to retain the important tax advantage of a depreciation deduction."^1

GENERAL CHARACTERISTICS

The term of an installment sale contract usually runs up to ten years longer than that made on a normal mortgage basis. However, an annual constant is set to liquidate the investment over a normal mortgage period at somewhat less than the current mortgage rate. The contract term, typically 35 years, provides for a closed period of 15 years, after which contract termination options are provided at five year intervals. A fifteen year "lock-in" may seem unreasonable until one realizes that the depreciation and interest factors will almost completely shelter the cash flow during the entire 15 years.

Although a fixed contract payment is used, the method of calculating interest and amortization are different. Under an ordinary mortgage, the interest portion of the constant payments decreases each year as the amortization portion increases. In an installment sale contract the annual amortization is determined by dividing the total amount paid off within the years the property is held by the number of years. The remaining portion of the constant payment is the interest paid. Such an arrangement makes it possible for the developer to accurately program the amount of interest and depreciation he will receive, knowing that they will remain constant. Most contracts will also allow for the balance due to be refinaceable at the time of selected prepayment.
LENDER IMPACT

The lender's desire to get greater returns for their investments, and an opportunity for participation, can readily be satisfied by a sale-buyback arrangement. In return for granting what will inevitably result in 100% refinancing, he will usually require a fixed contract payment with installments being broken down into constant interest and repayment of principal factors, and a contingent payment in the form of a percentage of net income less the contract payment. He thus, obtains an interest in a project that offers him an opportunity for growth, as well as longer than normal basic interest or a repurchase bonus, whichever favors the method of write off on his investment he intends to employ. A final factor which offsets the higher risk factor associated with a high ratio investment, is the extended closed-option period, giving a longer than normal period to benefit from the high yield investment.

DEVELOPER IMPACT

The leverage resulting from the ability to borrow 100% of his development cost is the main advantage to the developer. The installment contract allows for the certainty of a constant installment repayment at a realistic mortgage rate and allows the developer assurance that he will benefit from a regular annual income stream that is almost completely tax sheltered. The disadvantage of bringing a partner into the project who shares in the profits is somewhat reduced by the fact that
he primarily is a silent partner. The slower than normal rate of amortization may also be a desirable feature. However, if repaid amortization is important to the developer, or he feels the price of giving up income to a partner is not offset by the ability to obtain high ratio financing while retaining numerous tax advantages, it might be desirable to pursue another vehicle for refinancing.

EXAMPLE

An analysis of the Urban Office Building project will demonstrate the value of a sale-buyback arrangement.

After acquiring the land and doing a thorough feasibility study, the developer of the Urban Office Building can demonstrate to an institutional lender that the project represents a total cost of $9,200,000 and has an economic value of $10,000,000. Based on this, the lender agrees to purchase the project at the projected total cost and then sell it back to the developer. The repurchase contract calls for the developer to pay an annual installment of 8% of the purchase price over a 35 year period. The net income received after payment of the fixed contract payment and operating expenses will be apportioned 75% to the developer and 25% to the lender. The lender will hold title to the property until the contract has been paid off.

Project financing will be provided as follows:
Lender - 100% development cost (including land) $9,200,000
Developer - (none) -0-
Total Budget $9,200,000

The net income will be split in the following manner:

Net Income $1,000,000
Installment Contract Payment at 8% 736,000
Remaining Cash Flow $264,000

The remaining cash flow will be split as follows:

Lender gets 25% $66,000
Developer gets 75% 198,000

$264,000

The lender's share in the cash flow has the effect of raising the yield on his purchase price by about .75% during the first year. As net income increases, this will go even higher.

The developer has benefited from 100% financing of his total cost including land. In addition, the tax benefits of an annual accounting loss due to depreciation and interest deductions is sufficient to shelter his entire share of the cash flow and a lesser amount of income from other sources for a significant number of years. Thus, for only his time, and a reasonable amount of risk the developer will receive a sizable annual income and a highly favorable tax shelter. And, when the installment contract is paid out he will again have total ownership of the building.
CONTINGENT INTEREST

BASIC CONCEPT

A contingent interest rate arrangement is one that provides for the interest rate on a loan to be a combination of the normal fixed interest rate and an additional rate based on the performance of the property.

GENERAL CHARACTERISTICS

The simplest technique is to base this additional return on a percentage of gross income. More sophisticated contracts may call for a percentage of the gross in excess of a specified percentage of the gross income or a percentage of the gross in excess of a specified dollar amount. Others may provide for a percentage of overage rents paid by tenants on percentage leases, a percentage of net income before taxes and depreciation, or a percentage of a predetermined net income under
which certain items of expense are limited.

LENDER IMPACT

The lender whose return is based on a contingent interest agreement is in danger of exceeding the usury limitations if the project is too successful. "However, the transaction may be exempt (1) because of the nature of the borrower (in states with a corporate exemption); (2) if the transaction is for a 'business purpose' which, as in Illinois, constitutes a defense; or (3) according to recent enactment in several states, the loan is legal because it exceeds a certain amount."1

One method of averting the conflict of usury is to provide for the contingent interest to be cumulative. Interest not earned in one year, would then be carried over to be paid in subsequent years when it is earned. A stipulation that over the entire period of the loan the fixed plus contingent interest may not exceed the usury regulations could then be employed to protect the lender.

To avoid loss due to amortization and prepayment, the lender may require an additional equity interest over and above the fixed debt service and equal to the capitalized value of the

average amount of additional compensation paid in the years prior to prepayment. Or, he may require a predetermined share of the proceeds of refinancing in excess of the outstanding amount of the loan. Such compensation recognizes the equity position of the lender and allows him to reap the benefits of appreciation due to amortization of the mortgage he has provided. By making this additional participation a condition of prepayment predetermined by the borrower and the lender, he thus avoids the question of usury.

An added feature of the contingent interest technique is the ability to bargain it opens up for the lender. By creative application he may be able to offer a primary interest rate which is low enough to permit him to outbid rival lending institutions. By doing so, he corners the loan, has reason to request an interest participation, and is relatively sure that he will eventually receive a return that is equal to or greater than the interest rate initially offered by his competitors.

DEVELOPER IMPACT

A contingent interest loan is quite acceptable to a developer as it provides him with an initial interest rate that is lower than otherwise and also puts a degree of the risk in the project on the shoulders of the lender. If the project is not as successful as anticipated, the additional compensation will not
have to be paid. If it is successful, the developer will have the option of repaying the loan as soon as the "lock in" period is over and thus negating the lender's opportunity to share in the profits. The continuous reduction in principal during this closed period is also to the developer's advantage.

EXAMPLE
To assure that he will get the financing of the Urban Office Building project, a mortgage lender must outbid his competitor who offers a permanent mortgage of 75% of the economic value of the project or $7,500,000 at 8.5% interest for a 40 year term.

To do so, he offers the same loan amount at 8% over the same term, but charges a contingent interest equal to 2.5% of the gross rents after an allowance for vacancies has been made. This annual sum of $37,500 makes the total interest paid for the loan equal to that of the original offer. However, the contingent portion does not have to be paid until the project reaches the occupancy necessary to fulfill the gross rent requirements projected by the developer in the feasibility study. Thus, the lender assumes a portion of the risk involved, offers a lower interest rate, and in return stands to gain if the project income increases over that projected by the feasibility study. The developer benefits from an increased cash flow resulting from reduced debt service requirements while the project is leasing up or below full occupancy level.
A comparative cash flow analysis may be made as follows:

<table>
<thead>
<tr>
<th></th>
<th>8.5% Loan</th>
<th>8.0% Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Debt Service</td>
<td>660,000</td>
<td>622,500</td>
</tr>
<tr>
<td>Contingent Interest</td>
<td>-0-</td>
<td>37,500</td>
</tr>
<tr>
<td>Total Interest</td>
<td>$ 340,000</td>
<td>$ 340,000</td>
</tr>
</tbody>
</table>

An increase in the mortgage term would result in a lower debt service constant and an even more attractive initial cash flow for the developer. When the gross rent has reached or surpassed its projected maximum the lender's effective interest rate will be proportionately higher than if the contingent interest arrangement did not exist.
VARIABLE RATE MORTGAGE

BASIC CONCEPT

A variable rate mortgage provides for the interest on the mortgage to shift up or down within predetermined limits over the term of the loan.

GENERAL CHARACTERISTICS

This technique ties the interest rate of the mortgage to a predetermined index that will reflect the current cost of capital to the originating lending institution from either internal or external monetary sources. Whether tied to the rate paid on savings by the institution, to the prime rate of a major bank, or to the rate of long-term government bonds, when the index shifts up or down the interest rate on the loan adjust accordingly. Where the rate is tied to the lender's internal cost of capital, he will be able to maintain a degree of control
over the fluctuations. However, in most cases the change will be limited to no more than one percent above or below the original interest rate determined when the borrower accepted the loan.

A borrower may thereby be assured that he will never be required to pay interest more than one percent higher or one percent lower than that called for by the original loan rate. In a few cases, the lender has demanded the right to adjust the rate a maximum of one percent each way at his own discretion, independent of an index of any kind. Where this occurs, the borrower will usually be given adequate notice after which he will have a period to prepay the loan without a penalty if he so chooses.

LENDER IMPACT

The lender feels a variable rate is necessary to overcome the burden of obsolete and unprofitable rates on long term mortgages due to increasing inflation and continually rising interest rates. "In a period when market interest rates were rising, then a lender would get a better return on his existing mortgage portfolio and would have more funds to make new loans."  

DEVELOPER IMPACT

When interest rates are declining the borrower would benefit

as the rate of his original mortgage falls. Indirectly, the lender would benefit also, as it is in periods of falling interest rates that a borrower would cut his mortgage cost by refinancing his project and repaying his original loan. The variable rate tends to discourage such action, and thus preserves the loan obligation to the original lender.
WRAPAROUND MORTGAGE

BASIC CONCEPT
A wraparound mortgage, sometimes called a blanket mortgage or an extended first mortgage, is actually a form of second mortgage that allows a lender to advance funds to a borrower in excess of the amount of remaining balance on an existing first mortgage and/or to make it possible for the borrower to obtain terms on a new mortgage more favorable than those of the original mortgage, without requiring that the existing mortgage be paid off.

GENERAL CHARACTERISTICS
Obligations of the existing mortgage are assumed by the wraparound mortgage lender by placing another, and usually larger mortgage on the property. If the loan amount is for a larger amount than the outstanding balance of the first mortgage, the
new lender advances the difference to the borrower and then begins receiving periodic payments on a new loan amount equal to the outstanding balance of the original mortgage, plus the amount of additional funds granted. Conditions of this new loan generally provide for a longer payout term and a higher interest payment for the entire amount outstanding. In turn, the wraparound lender then makes periodic debt service payments to the holder of the original mortgage. "The wraparound mortgagor is not required to assume the existing mortgage, but can agree to meet the debt services out of the payments received on the 'wraparound' mortgage." Thus, the borrower no longer has direct dealings with the original lender.

In some instances the wraparound mortgage may cover only the amount to the outstanding balance of the original first mortgage. Justification for the increased interest rate of the new loan must then come from favorable terms for repayment that are considerably different from those of the existing first mortgage.

**LENDER IMPACT**

The lender of a wraparound mortgage receives the benefit of leverage made possible by the existence of a low interest rate.

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on the original mortgage. Although the new loan will usually have an interest rate below the conventional loan market, return on the actual funds invested will usually be very high. The return on this investment, which in this case is only the amount of funds that he has extended above and beyond the existing balance on the assumed first mortgage is a composite of the following:

(1) Interest and amortization of the new cash outlay above the balance of the first mortgage.

(2) An amount equal to the difference in interest rates on the wraparound mortgage and the interest rate of the first mortgage on the amount of the original balance.

This composite return makes it possible for the lender to grant the cash and terms sought by the developer and still receive a composite yield somewhat higher than that offered by the current money market while at the same time retaining the quality and type of security it would normally require. In addition, the cash advanced will not usually exceed the 75% loan-to-value ratio normally permitted.

DEVELOPER IMPACT

A wraparound mortgage can be used to greatest advantage when the borrower is "locked-in" to a first mortgage having terms that are undesirable. It can best be employed when:

(1) The owner of a project several years old decides he would prefer to refinance rather than sell the property in question.

(2) The borrower needs more cash and the mortgagor
Wraparound Mortgage

will not make additional advances under the existing mortgage.

(3) The debt service on the existing mortgage proves to be unfavorable to the borrower and the holder of the first mortgage refuses to renegotiate terms.

(4) The first mortgage contains clauses that either prevent prepayment or allow repayment only if extreme penalties are met by the borrower.

(5) The first mortgage has substantially low interest rate that makes prepayment impractical, but existence of additions, improved leasing and/or increased property value justify a much larger loan based on the current value of the property.

In cases where a project has been under the first mortgage for a number of years, the owner may elect to refinance the project rather than sell it and thus reclaim his equity. A wraparound mortgage will permit him to bypass any unfavorable prepayment clauses that may exist, and/or to retain any advantage or lower interest rates on the original loan that might accrue. "The borrower thus is able to get some or all of his equity investment out of the project (usually without paying any federal income or capital gain taxes) and will probably have loan terms more favorable than would exist if the total mortgage debt was completely refinanced. Moreover, a larger portion of his debt service payments would again be tax deductible interest."}

EXAMPLE

To demonstrate the impact of the wraparound mortgage, the Urban Office Building may be considered having its mortgage paid off to a point where $5,000,000 of the initial loan amount remains to be paid.

Assuming that an accelerated rate of depreciation has greatly reduced the tax shelter that remains and that an increasing amount of the debt service is going to paying amortization on the loan, it can be seen that the cash flow is no longer advantageous to the owner. However, a prepayment penalty makes normal refinancing and early payoff of the original loan impractical and uneconomical. The owner also needs additional cash to make needed improvements on the property.

If a lender can be found who will commit a wraparound mortgage equal to the economic value of the project at 9% interest while assuming the first mortgage, both the lender and borrower will benefit. The new lender will only have to advance an additional $5,000,000 which would be subordinated to the existing first mortgage. He will then collect interest of 9% on the total mortgage value of $10,000,000 and, in turn, pay the 8.5% interest on the first mortgage. His actual return would be the difference between the $900,000 earned on the overall loan and the $425,000 interest he must remit to the holder of the first mortgage. The lender therefore earns $475,000 on an original investment of $5,000,000, giving him an annual net return of 9.5 percent.
At the same time, the owner has reinstated a favorable tax shelter, is no longer obligated by an undesirable repayment clause, and has received an additional $5,000,000 that is not subject to income tax. He may also have obtained an extended payout period that will reduce his overall annual debt service.
SPECIAL LOANS

BASKET CLAUSE LOAN

"A basket clause loan, is not technically a type of loan; rather it is a provision in some state regulations for insurance companies which permit life insurance companies to make a small percentage of their loans in a category that cannot be assigned to any of the traditional real estate classifications." In New York, for instance, the laws allow insurance companies to use 2% to 3% on loans that would not otherwise be acceptable. Basket Clause Loans may be used for accommodating a variety of creative financing techniques such as a wrap-around mortgage, a loan secured by a lease, but not by a mortgage, and loans which may exceed the specified loan-to-value

ratios. Other techniques may also require basket posting varying according to the law in the state where they are implemented.

STOCK OWNERSHIP OR OPTIONS

In cases where stock, stock warrants, options, and convertability features are used as collateral to secure funding for a development project, the lender runs the risk that the borrower or majority stockholder will not declare dividends for an extended period. Thus his participation will be postponed. If a declaration is made, the lender's gains are subject to the double taxation inherent to corporate dividends. It is therefore, important that the borrower be a well established corporation with an active market for selling or reselling stock. Even when conditions and features are attractive enough to warrant participation, the lender may request an option over a period of time to convert, at a given conversion price, the unpaid balance of the mortgage it holds into common shares of the borrowers corporation. Such privileges of conversion and participation may make it possible for the lender to grant a more favorable interest rate to the borrower.

BONDABLE NET LEASE

When a tenant has a very high credit rating and a proven history of earnings and is willing to enter into a noncancelable absolutely
net lease which provides a net rental sufficient enough to cover the mortgage payments, it may be possible for the developer to receive what is essentially a direct 100% loan. As the lender is looking primarily to the credit of the tenant in lieu of the real estate for security, the credit standing of the borrower becomes insignificant. "The tenant usually leases a major portion of the property, and the lease is sufficient with the rental income from the tenant, to amortize the loan completely within the lease period." High credit institutions such as a municipality, hospital or major corporation using this arrangement, will usually create a separate real estate subsidiary that will hold the title to the property and lease it to the parent corporation.

LENDER'S JOINT POOL FINANCING

Several lenders in the same market area participating in the same project may combine funds to provide interim construction financing for the larger than normal construction project. By using one mortgage and several notes, a "money pool" is created by equal contributions from each lender from which construction funds may be drawn. Such joint ventures permit lenders to compete for loans that might otherwise have to be originated from outside the immediate area.

Permanent loans, on the other hand, are not usually financed by such joint commitments. Instead the participating lenders each receive a preassigned portion of the completed project on which they may provide a standard mortgage commitment.

**DIVIDED AMORTIZATION SCHEDULE**

This arrangement provides for divided amortization rates on separate parts of the loan so that faster amortization occurs on one portion than on the other. Such a schedule allows the lender to recapture a significant portion of its capital much earlier than under normal amortization. In some cases, an interest only charge, similar to that used in a balloon mortgage may be used for several years before a complete amortization schedule is enacted.

**PIGGYBACK LOANS**

By sharing or participating in a combined loan, two or more lenders may provide a loan higher than the normal loan-to-value ratio of 75% of the economic or appraised value of the property. Up to 90% of this value may be provided if 75% of the money is provided by the institutional lender who originated the piggyback loan and 15% is provided by a private lender. The primary investor occupies a senior position and holds the documents for both lenders.

To protect the secondary lender, private mortgage insurance
is obtained on his portion, and retained until the loan is reduced to the normal ratio of 75%. His claim to the insurance is of course, exempt from the other lender's senior claim. "The piggyback is in essence a form of junior or second-mortgage financing with the prime investor owning 75 percent of a 90 percent mortgage and another investor owning a subordinated 15 percent interest."  

In some cases collateral for the loan amount above the normal ratio may be put up by the borrower or a third party, and the entire 90 percent financing provided by the permanent investor. This collateral may be in the form of time deposits or guarantees by an outside institution, but must be sufficient to secure the "top" or "excess" part of the loan. If the borrower does use such a "passbook loan agreement" he deposits the sum in a savings account which draws interest.

Although the developer can withdraw the interest, the principal sum must remain on deposit until the outstanding loan amount is reduced to the size of a standard first mortgage that would have been granted under the same circumstances. Other than an outside institution, an assignment of stock, letter of credit or certificate of deposit may be used as collateral. Such

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collateral, gives the lender significant security to overcome the risk of an extremely high ratio loan on unusual property.

**BALLOON LOAN**

Unlike a conventional mortgage which provides for the periodic debt service to fully pay off the loan amount, a balloon loan provides for only partial amortization during the initial term of the loan. Upon maturity, the remaining principal outstanding must be paid, refinanced, or extended as a portion of the original mortgage. A long-term loan that exceeds the term of the lease it covers may also be considered a "balloon loan". The difference between the two terms is referred to as a "hangout".

The attractiveness of a balloon loan to a borrower is found primarily in the tax advantages it offers. By reducing or slowing down the rate of amortization, the tax shelter provided by depreciation will be adequate to shelter appreciation from amortization for a longer period of time. The borrower is thus able to postpone the time when he will be paying taxes on income he does not receive.

A secondary benefit is accrued when the loan termination date is reached. Whether the borrower chooses to refinance at a higher figure than the outstanding "balloon" or to extend the loan with lower amortization, he stands to acquire a greater cash income from his property. In turn, the lower amortiza-
tion may be sufficient to fall within the shelter of the depreciation deductions which are also reduced. Either approach will provide additional funds for repairs, or recapture of the initial equity. Should the current interest rate be lower at the renewal date the borrower will also receive a benefit that might not have evolved had the financing been under a standard mortgage of a necessarily longer term.

The lender is willing to go along because he has the property, rather than the credit of the borrower, as security. He is also relatively assured to getting a renewed or extended loan on the balance of the loan. During the new term he will have the same security, receive additional interest, and see the balance farther amortized.

THE ANNUAL CONSTANT

The annual constant is the debt service of a mortgage stated as a percentage of the original debt. It determines the amount of principal and interest required to pay off the mortgage as well as the rate at which the principal will be reduced. Under normal circumstances, the interest portion of the first payment will be the difference between the amount called for by the annual constant and that called for by the annual interest rate. The remaining portion will go toward reducing the principal. After this initial payment, interest is paid on only the remaining amount of principal, and thus becomes smaller with
each additional payment while the principle reduction will increase.

By maintaining the annual constant, and adjusting the interest rate and term of the mortgage, it becomes possible to accommodate special financing requirements of both the lender and the borrower.

By creatively using the annual constant, it is possible to vary the interest rate while maintaining a specified annual debt service amount. "The principal and interest portions of the constant may be planned to give the lender a particular rate of return and at the same time to give the developer the debt service factor which he desires."  

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CREATIVE FINANCING

BASIC CONCEPT

The ever increasing size and complexity of development projects have required that developers have larger amounts of capital, while at the same time providing added incentive for both developers and lenders to take on the additional risk of large loans. Expanded construction cost, prolonged periods of inflation and a tight money market have further compounded the problems of both lender and borrower.

It has therefore, been necessary to create new approaches for providing satisfactory loans in situations that would be impossible to finance by traditional methods using the normal pattern of long-term mortgage and a fixed interest rate. Thus, creative financing may be defined as solving of unusual and special financing needs of both lenders and borrowers in
situations where normal approaches are inadequate. "It is a matter of taking the new materials of a problem in financing, combining them in a new way, or adding new ingredients thereby coming up with an acceptable product which can be purchased by lending institutions."^1

GENERAL CHARACTERISTICS

Although numerous methods can be employed to achieve the additional yields sought by lenders, almost all techniques involve the use of "kickers" or "sweeteners" conceded to the lender by the developer. "This means that the financing is arranged to provide the lender an income beyond a fixed return - a yield in addition to the straight interest."^2 It is this additional incentive, attached to the basic obligation that makes an unusual or high-ratio financing situation attractive enough to be acceptable to the lender.

Methods used to acquire the benefits of a "kicker" will vary, but in most cases will include either the right to participate in the income, profits or equity ownership of the project, the right to charge nonrefundable fees and discounts, or a combination of any or all of these.


In spite of the benefits that may accrue, to the lender through additional investment outlets and higher yields, and to the borrower through advantages of leverage and increased scale of operations, many lenders and developers feel that creative techniques are gimmicks that will disappear when inflation is brought into some degree of control and money becomes more available. From the lender's standpoint there may be a concern for jeopardizing their portfolio through unknowingly violating the usury regulations which determine a ceiling for the legal rate of interest. Vocal protestations by borrowers who feel that lenders, through participation, are demanding yields in magnitudes not commensurate with the degree of additional risk assumed, tend to perpetrate the lender's anxiety.

Actually, recent trends have been toward liberalization of the statutory lending restrictions and the result has been increasing use of creative techniques whether justified or not. Whether or not the usury laws are indeed violated is a legal question that has not to date been unanimously agreed upon by the courts. Nevertheless, as there will always be financing problems that must be overcome, especially as related to large scale or unusual projects, creative financing will undoubtedly continue to be used by those concerned with the more sophisticated realms of real estate financing. The intensity of use will vary with the conditions of the current money market. "Yields must be attractive both to the borrower-
CREATIVE FINANCING

developer and lender, and the market must be willing and able to pay the price to support the yields.\(^1\)

LENDER IMPACT

It is the potential for higher yields from their investments that make creative financing techniques attractive to the commercial or institutional lender. Continuing periods of inflation and tight money has brought about a declining purchasing power for the lender's investment portfolio while at the same time increasing operating expenses. When combined with the additional risk incurred by committing long-term capital to extremely large scale and increasingly complex development projects, these factors are significant enough to initiate the lender's desire for greater fiscal involvement. The prevalence of inflation is not, of course, the only reason lenders are seeking equity participation in development projects. After watching developers leverage small cash investments into large profits for so many years, it is inevitable that they would eventually seek "a piece of the action" in addition to what they consider all too moderate interest rates returned on conventional mortgages.

DEVELOPER IMPACT

To achieve the high ratio financing which is his primary goal,  

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the developer must, in effect, take on the lender as a participating partner. However, the ability to obtain larger than normal sums of capital may permit the developer to undertake projects of a much larger scope than might ordinarily be possible within the limits of his resources. Combined with the financial leverage inherent to 100% financing of his projects, the economics of developing on the larger scale may be favorable enough to more than offset the price that has been paid through dilution of his equity. In addition, many creative financing techniques are so structured as to provide the owner-entrepreneur with an income that is almost totally tax sheltered.

EXAMPLE

A classic example of the values accrued through imaginative implementation of creative financing can be found in the examination of a technique first employed by William Zeckendorf in 1953, when his real estate and development company, Webb and Knapp, was involved in the purchase and resale of 1 Park Avenue in New York.  

Using conventional techniques of a straight mortgage and a second mortgage, based on a ratio of the economic value of

the property, the firm found they could only raise eighty percent toward the required purchase price. Even though the outstanding twenty percent was not available, a decision to proceed with drawing up the papers for the transaction was made.

This decision was not entirely without reason, for Mr. Zeckendorf realized that if he could get commitments from investors to purchase the building once it was under his control, such a commitment would generate the financing needed to acquire it in the first place.

While vacationing in Hawaii, Mr. Zeckendorf, a pioneer and major inventor of creative financing techniques, arrived upon the concept of fractioning off the various values of the project, much in the same way an investment broker sells the ownership and rights in a corporation of which he must dispose. The result of this ingenious concept was the evolution of what has come to be known in the real estate profession as the "Hawaiian Technique". Although in practice, this process involves a long line of interconnected transactions and lateral interactions, the basic concept is relatively simple.

Beginning with the realization that an urban property may be readily broken into two parts, the land and the ground lease, the first step is to determine the percentage of the total income that will go to ground rent. Since ground rent, must
be paid before any expense, it is the safest of all possible incomes to an improved property.

Once this income has been capitalized, it is then possible to sell the rights to it directly, or to acquire a mortgage for it using the ground as security. Having done the latter, the amount of income remaining after the periodic payment on the mortgage has been made could then be capitalized and the rights to it sold to an institutional or individual investor.

After having first mortgaged and then sold off the land, the entrepreneur would then have a sizable amount of cash, plus the building and a lease giving him unrestricted use of the property. The income of the leasehold would be the earnings from the property remaining after the ground rent had been paid.

To maximize the value of this leasehold it is necessary to break it up into smaller leases which are attractive to particular types of buyers. The first lease, known as an inner or sandwich lease, would be sold to an individual who might be considered as the building owner. He would receive a sizable rent from the holder of the second lease and in turn pay a portion of it as ground rent to the owner of the land. The second lease, known as the outer or operating lease, would be purchased by the individual who in effect would be the
manager of the building. His income would represent the total rent derived from tenants using the building.

Before selling the inner lease its income could be capitalized and mortgaged, and the amount remaining after the periodic mortgage payments could then be capitalized and sold. In turn, the operating lease could be capitalized and sold to an investor for a sizable sum. Of course, the return to the original entrepreneur could be even greater if he decides to provide financing, by taking back the mortgage on the various leaseholds.

In essence, what has been done in this simplified example is a fractioning off of the property by first selling and mortgaging the land; second, selling and mortgaging the inner lease; and third, selling an operating lease. The end result is a return to the entrepreneur much higher than the price for which he will purchase the building.

The concept becomes clearer when the various participants are compared to the individual creditors of a corporation. The building manager, holder of the outer operating lease is in a position similar to that of a common stockholder. His position is secure against inflation, and a rise in sales or rents will give him a considerable rise in income. The building owner, holder of the inner or sandwich, has a fixed income much like a preferred stockholder, plus the additional advantage of a tax shelter accrued through depreciation of the building.
The land owner and mortgagor are in a position similar to that of a corporation bond or debenture holder. The accumulated result of all of these is a profitably fractioned income that offers a secure investment to all who participate as well as a sizable return to the individual who instigated the venture.

In actuality, the transaction would inevitably be more complex and involve a greater number of participants. The introduction of second mortgages alone, would undoubtedly double the complexity of the involvement. It is the flexibility permitted by the "Hawaiian Technique" that is its primary virtue. Because it makes it possible to anticipate and capitalize on future earnings of a property, the technique has become a major tool providing liquidity and flexibility to the world of real estate finance.

Application of the Hawaiian Technique for simultaneous purchase and resale of the Urban Office Building project having an economic value of $10,000,000 and an annual net income of $1,000,000 would be made as follows:

1. The land, having an economic value of $2,500,000 can be ground leased at 10% ground rent per year. The rights to the income from this ground lease can be mortgaged at 80% of the economic value or $2,000,000. A 7.5% debt service constant requires that $150,000 of the ground rent go to paying debt service. This leaves $100,000 net income which can be capitalized and sold to an investor seeking a fixed return of 8% for an investment of $1,250,000.

| Ground Lease |
| Net Income    | $250,000 |
### Ground Lease - Continued

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Capitalization Rate</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Economic Value</td>
<td>$2,500,000 / .10</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$2,500,000</td>
<td></td>
</tr>
<tr>
<td>Mortgage Ratio</td>
<td>80%</td>
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<tr>
<td>Mortgage Amount</td>
<td>$2,500,000 x .80</td>
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<td></td>
<td>$2,000,000</td>
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<tr>
<td>Debt Service Constant</td>
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<tr>
<td>Debt Service</td>
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<tr>
<td></td>
<td>$150,000</td>
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<tr>
<td>Gross Profit</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Desired Rate of Return</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>Sales Price</td>
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<tr>
<td></td>
<td>$1,250,000</td>
<td></td>
</tr>
<tr>
<td>Total Value</td>
<td></td>
<td>$3,250,000</td>
</tr>
</tbody>
</table>

(2) A sandwich lease that receives an annual income of $750,000 pays $250,000 annual ground rent and provides the owner with $500,000 in gross profit. This $500,000 when capitalized at 10% has an economic value of $5,000,000 that can be mortgaged for 80% of its value or $4,000,000. A fixed annual return of 8% requires a debt service of $320,000 leaving $180,000 gross profit to the owner. This amount can be capitalized at 9% and sold for $2,000,000.

### Sandwich Lease

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>$750,000</td>
<td></td>
</tr>
<tr>
<td>Ground Rent</td>
<td>$250,000</td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>$500,000</td>
<td></td>
</tr>
<tr>
<td>Capitalization Rate</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Economic Value</td>
<td>$500,000 / .10</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$5,000,000</td>
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</tr>
<tr>
<td>Mortgage Ratio</td>
<td>80%</td>
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<tr>
<td>Mortgage Amount</td>
<td>$4,000,000</td>
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<tr>
<td>Debt Service Constant</td>
<td>8%</td>
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<tr>
<td>Debt Service</td>
<td>$4,000,000 x .08</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$320,000</td>
<td></td>
</tr>
<tr>
<td>Gross Income Profit</td>
<td>$180,000</td>
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</tr>
<tr>
<td>Desired Rate of Return</td>
<td>9%</td>
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<tr>
<td>Sales Price</td>
<td>$180,000 / .09</td>
<td></td>
</tr>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Total Value</td>
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<td>$6,000,000</td>
</tr>
</tbody>
</table>
(3) An operating lease having a gross income of $1,000,000 pays the sandwich lease owner $750,000 annual rent leaving $250,000 gross profits to the owner. When capitalized at 10% this lease can be sold to an investor for $2,500,000.

<table>
<thead>
<tr>
<th>Operating Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
</tr>
<tr>
<td>Annual Rent</td>
</tr>
<tr>
<td>Gross Profit</td>
</tr>
<tr>
<td>Desired Rate of Return</td>
</tr>
<tr>
<td>Sales Price</td>
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</tr>
</tbody>
</table>

Total Value $2,500,000

The sum of the sales and mortgage values received by the entrepreneur who instigates the simultaneous purchase and resale of the property is $11,750,000. This is $1,750,000 above the price he must pay for the building leaving a gross profit to him, exclusive of broker's fees, of 17.5% of the purchase price of the property.

<table>
<thead>
<tr>
<th>Total Sales and Mortgage Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ground Lease</td>
</tr>
<tr>
<td>Sandwich Lease</td>
</tr>
<tr>
<td>Operating Lease</td>
</tr>
<tr>
<td>Total Value</td>
</tr>
<tr>
<td>Purchase Price</td>
</tr>
<tr>
<td>Profit</td>
</tr>
</tbody>
</table>

CONCLUSION

"All useful things owned by man are classified as wealth.... Property on the other hand, is an intangible concept, being
the right to own or possess wealth, and to put to legal use if one wishes.\textsuperscript{1}

This concept of property is clarified if one realizes that the value of urban property is divided into two parts. The first being ownership of the land itself, and the second the lease on the land which gives the holder the right to use the land in any way he sees fit, as long as he continues to pay the required ground rent. If an improvement, a building, exist on the land, the right to use, alter, tear down, or rebuild on the site is a privilege of the leaseholder, unless specifically provided for otherwise by the agreement. Income to the property may thus be derived from both the value of the ground rent and values accrued from use of the improvements.

The variations and complexity of the creative financing techniques that may be employed to derive income from the multiple values of an urban property are limited only by the imagination, versatility and ingenuity of the various individuals involved in the transaction. "The greater the number of separate groups (or their needs) that one could interconnect (or satisfy), the greater the profit to the innovator-entrepreneur."\textsuperscript{2}

\begin{enumerate}
\end{enumerate}
CONCLUSION

Whereas many of the professionals who may be identified as participants in the development process have played only a minor role on the development team of the past, it is possible that a significant number of these will have a greater part in directing urban growth of the future. A rapidly growing population and increases in both privately sponsored and government sponsored new development, redevelopment and new communities have brought about larger sized and more complex income producing real estate projects. The result is a greater need for continuing participation by all members of the development team from initiation to conclusion of most development projects.

Such comprehensive involvement will attract the developer-investor-client because it places the entire burden of planning financing, construction, leasing of space, and perhaps even building operation in the hands of qualified professionals who
are well versed in the latest creative methods and techniques of development and fully capable of bringing the development process up to the standards set by other contemporary productive enterprises. As each discipline becomes merely a contributing service offered to the total process, over emphasis of any one expediency will be less likely, and each member of the development team may pursue and project his full creative capacity without fear of dilution by the others.

Once investors and developers are convinced that full level contribution by a multitude of participants is viable, and that organization of such groups is in their best interest, it is quite possible that the conflict of profit versus quality can be at least partially resolved. Expertise directed toward the integration of creative financing techniques with the creative goals of the development team should have an especially large impact on the amount and allocation of funds that may be directed toward the concern for quality in built facilities. The ability for an owner to remain profit oriented and simultaneously attain a high degree of design quality in his projects will be enhanced by the presence of adequate financing and the encouragement of development professionals of undisputed integrity.

It is redundant to say that the inclination to cut cost for the sake of maximizing profits will not continue to exist in some cases. "As long as the market place is structured so that
exorbitant profits can be obtained from poorly designed and ugly buildings, those buildings will be built, whether the chief officers of the developers are architects or accountants.\textsuperscript{1} Already, there are professionals who give quality high priority and others who do not. It is possible however, that on the whole, buildings planned and developed by a development team of qualified professionals will be of better quality than if done solely by an individual who is ignorant of, or indifferent to, the possibility of attaining both quality and profit.

A positive effect on the environment may result if the development team can enter the investment development process on a broad scale. Recent trends toward development of large projects in the form of totally new communities, new towns in town, and redevelopment areas controlled by major corporate and institutional entities, may offer the best opportunity for these professional groups to have a significant impact. By defining community needs, and then creating a client entity to fulfill that need, the entire development team may become a part of the client, establishing for each of its members a voice in determining the destiny of the project at hand.

A market for quality in the built environment does exist, and

CONCLUSION

continuing involvement by the federal government, increasing public awareness, and constantly rising standards of living will both accelerate and perpetuate this market. A definite rational to urban growth and change also exist. A proper response to existing and projected conditions can both enhance the value of a development and greatly reduce the amount of risk inherent to investment of this nature. Creative development financing offers a great deal of latitude for establishing the financial parameters within which a proposed project may be effectuated. As such, the rate of return on an initial investment may be directly affected by the extent or imagination, versatility, and ingenuity employed by those responsible for the initial financing package.

From a utopian point of view, it appears that the ideal developer might be a group of professionals guided by an abiding concern for quality and order in the urban environment and a positive respect for the impact of practical economics.

Raymond L. Burroughs, AIA
Rice University
May, 1972
Abstract of Title A summary or digest of the conveyances, transfers, and any other facts relied on as evidence of title, together with any other elements of record which may impair the title.

Acceleration Clause A clause in a trust deed or mortgage giving the tender the right to call all sums owing him to be immediately due upon the happening of a certain event.

Acknowledgement A formal declaration before a duly authorized officer by a person who has executed an instrument that such execution is his act and deed.

Administrator A person appointed by the probate court to administer the estate of a person deceased.

Ad valorem Latin for according to value.

Adverse Possession The open and notorious possession and occupancy under an evident claim or right, in denial of, or opposition to, the title of another claimant.

Agent One who represents another from whom he has derived authority.

Agreement of Sale A written agreement or contract between seller and purchaser in which they reach a meeting of minds on the terms and conditions of a sale.

Amenity That which contributes satisfaction rather than money income to its owner.

Amortization The liquidation of a financial obligation on an installment basis.

Appraisal An estimate and opinion of value.

Assessed Value A valuation placed upon property by a public officer or board as a basis for taxation.

Assessment The valuation of property for the purpose of levying a tax or the amount of the tax levied.

Assignee One to whom property is transferred.

Assignor One who assigns or transfers property.

Assumption of Mortgage The taking of title to property by a grantee, wherein he assumes liability for payment of an existing note becoming a conguarantor for the payment of a mortgage or deed-of-trust note.

Attachment Seizure of property by court order, usually done to have it available in event of judgment is obtained in a pending suit.

Balloon Payment The final installment payment on a note when that payment is greater than the preceding installment payments and pays the note in full.

Beneficiary (1) One entitled to the benefit of a trust; (2) one who received profit from an estate, the title of which is vested in a trustee; (3) the lender on the security of a note and deed of trust.

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Blanket Mortgage A single mortgage which covers more than one piece of real estate.

Borrower One who for a commission or fee brings parties together and assists in negotiating contracts between the parties.

Capitalization In appraising, determining value of property by considering net income and percentage of reasonable return on the investment.

Capitalization Rate The rate of interest which is considered a reasonable return on the investment and is used in the process of determining value based upon net income.

Collateral Stocks, bonds, evidence of deposit, and other marketable properties which a borrower pledges as security for a loan. In mortgage lending, the collateral is the specific real property.

Commission An agent's compensation for performing the duties of his agency; in real estate practice, a percentage of the selling price of property, percentage of rentals, etc.

Commitment A pledge or a promise or firm agreement to make a loan.

Compound interest Interest paid on original principal and also on the accrued and unpaid interest which has accumulated.

Conditional Sale Contract A contract for the sale of property stating that delivery is to be made to the buyer, title to remain vested in the seller until the conditions of the contract have been fulfilled.

Execute To complete, to make, to perform, to do, to follow out; to execute a deed is to make a deed, including especially signing, sealing, and delivery; to execute a contract is to perform the contract, to follow out to the end, to complete.

Federal Home Loan Bank (FHLB) One of the 12 federally chartered regional banks of the Federal Home Loan Bank System. A bank's primary function is to supply credit to member institutions.

Federal National Mortgage Association (FNMA, also called Fanny May) quasi-governmental corporation which supplements private mortgage funds by buying and selling FHA and VA loans.

Federal Savings and Loan Insurance Corporation (FSLIC) An instrumentality of the federal government which insures the savings account in member institutions.

Fee The highest type of interest a person can have in land. Absolute ownership (subject to laws) with the right to dispose of it or pass it on to his heirs as he sees fit. The term "fee" is of Old English derivation.

Fee Simple In modern estates, the terms "fee" and "fee simple" are substantially synonymous.

Fiduciary A person in a position of trust and confidence.

Financial Intermediary A financial institution which acts as an intermediary between savers and borrowers by selling its own obligations for money and, in turn, lending the accumulated
funds to borrowers. The classification includes savings associations, mutual savings banks, life insurance companies, credit unions, and investment companies.

Foreclosure A procedure whereby property pledges as security for a debt is sold to pay the debt in event of default in payments or terms.

Forfeiture Loss of money or anything of value due to failure to perform for instance under an agreement to purchase.

Garnishee To attach a specified sum from wages to satisfy a creditor.

Graduated Lease A lease which provides for a varying rental rate, often based upon future determination; sometimes rent is based upon the result of periodic appraisals; used largely in long-term leases.

Grantee The purchaser of property; a person to whom a grant is made.

Grantor The seller of property; the one who signs a deed.

Gross Income The total income from property before any expenses are deducted.

Hundred Percent Location A city retail-business location which is considered the best available for attracting business.

Hypothecate To give a thing as security without the necessity of giving up possession of it.

Income Property A property which produces a money income to the owner.

Installment Note A note which provides that payments of a certain sum be made on the dates specified in the instrument.

Interest Rate The percentage of a sum of money charged for its use.

Involuntary Lien A lien imposed against property without consent of an owner.

Joint Tenancy Joint ownership by two or more persons with right of survivorship; all joint tenants own equal interest and have equal rights in the property.

Judgment The final determination of a court of competent jurisdiction of a matter presented to it; money judgments provide for the payment of claims presented to the court or are awarded as damages.

Junior Mortgage A lien that is subsequent to the claims of the holder of a prior mortgage.

Land Contract A contract ordinarily used in connection with the sale of property in cases where the seller does not wish to convey title until all or a certain part of the purchase price is paid by the buyer; often used when property is sold on small downpayment.

Lease A contract between owner and tenant, setting forth conditions upon which the tenant may occupy and use the property and the term of the occupancy.

Leasehold The estate held by virtue of a lease.
Lessee  One who contracts to rent property under a lease con-
tract.
Lessor  An owner who enters into a lease with a tenant.
Lien  A form of encumbrance which usually makes property secu-
rity for the payment of a debt or discharge of an obligation.
Examples: judgments, taxes, mortgages, deeds of trust.
Liquidity  The cash position of an association measured by the 
cash on hand and securities quickly convertible into cash.
Loan  A sum of money lent at interest to be repaid.
Loan Fee  The charge made at the granting of a loan in addition 
to required interest.
Market Value  (1) The price at which a willing seller would sell 
and a willing buyer would buy, neither being under abnor-
mal pressure; (2) as defined by the courts, the highest price 
estimated in terms of money which a property will bring if 
exposed for sale in the open market, allowing a reasonable 
time to find a purchaser with knowledge of property's use 
and capabilities for use.
Mechanic's Lien  A claim, created by statutory law in most 
states, existing in favor of mechanics or other persons who 
have performed work in, or furnished materials for, the 
erection or repair of building.
Moratorium  The temporary suspension, usually by state, of the 
enforcement of liability for debt.
Mortgage  An instrument recognized by law by which property is 
hypothecated to secure the payment of a debt or obligation; 
procedure for foreclosure in event of default is established 
by statute.
Mortgage Insurance Premium  The amount paid by the borrower 
for insurance by the FHA of a loan.
Mortgagor  One who gives a mortgage on his property to secure 
a loan or assure performance of an obligation; a borrower.
Net Income  The part of the gross income which remains after 
the deduction of all charges or costs including necessary 
reserves.
Nominal Interest Rate  The interest rate stated in the loan 
agreement.
Note  A signed written instrument acknowledging a debt and 
proposing payment.
Obsolescence  Loss in value due to reduce desirability and 
usefulness of a structure when its design and construction 
become old-fashioned and not in keeping with modern needs.
Open-end Mortgage  A mortgage which states the intention of 
the borrower and of the lender that the mortgage shall 
stand as security not only for the original loan but also 
for future advances that the lender may be willing to make.
Option  A right given for a consideration to purchase or lease 
a property upon specified terms within a specified time.
Participation Loan  A mortgage loan in which more than one 
association has an interest. One association makes the 
loan, and one or more associations purchase an interest 
in the loan.
Partnership  As between partners themselves, a contract of two or more persons to unite their property, labor, or skill or some of these, in prosecution of some joint and lawful business, and to share the profits in certain proportions.

Percentage Lease  A lease on property the rental for which is determined by the amount of business done by the lessee; usually the rental is a percentage of gross receipts from the business.

Personal Property  Any property which is not real property.

Points The amount of a discount stated as a percentage.

Prepayment Penalty A penalty for the payment of a debt before it actually becomes due.

Present Value  The current value of an amount to be received in the future.

Principal The amount of debt.

Proration of Taxes The division of taxes equally or proportionately to time of use.

Purchase-money Mortgage or Trust Deed A trust deed or mortgage given as part or all of the purchase consideration for property.

Quitclaim Deed  A deed to relinquish any interest in property which the grantor may have.

Reconveyance  The transfer of the title of land from one person to the immediately preceding owner. This particular instrument is commonly used when the performance or debt is satisfied under the terms of a deed of trust and the trustee conveys the title he has held on condition back to the owner.

Recourse The right to claim against a prior owner of a property or note.

Redemption Buying back one's property after a judicial sale.

Release Clause  A stipulation that upon the payment of a specific sum of money to the holder of a trust deed or mortgage, the lien on a specific described lot or area shall be removed from the blanket lien on the whole area involved.

Reserves Those portions of earnings which have been set aside to take care of possible losses in the conduct of business; listed in the balance sheet as a liability item.

Right of Way A privilege operating as an easement upon land, whereby the owner, by grant or by agreement, gives to another the right to pass over his land, to construct a roadway, or to use as a roadway a specific part of his land, or gives the right to construct through and over his land telephone, telegraph, or electric power lines, or gives the right to place underground water mains, gas mains, or sewer mains.

Risk The probability of future loss.

Risk Rating A process by which various risks are evaluated, usually employing grids to develop precise and relative figures for the purpose of determining the over-all soundness of a loan.
Sales Contract  A contract by which buyer and seller agree to terms of a sale.

Savings and Loan Association  A financial intermediary which receives savings and invests these savings mainly in mortgage loans. Always a corporation, it may be either a mutual or a capital stock institution and may be either state chartered or federally chartered.

Savings Bank  A financial intermediary which receives savings in the form of deposits and invests these deposits in mortgages and other securities allowed by law. The banks, with the exception of a few in New Hampshire, are mutual institutions and are governed by self-perpetuating boards of trustees.

Secondary Financing  A loan secured by a second mortgage or deed of trust on real property.

Security  Something given, deposited, or pledged to make secure the fulfillment of an obligation or the payment of a debt.

Servicing  The collection of payments on a mortgage. Servicing by the lender also consists of operational procedures covering accounting, bookkeeping, insurance, tax records, loan-payment follow-up, delinquent-loan follow-up, and loan analysis.

Sheriff's Deed  A deed given by court order in connection with the sale of property to satisfy a judgment.

Sinking Fund  A fund set aside from the income from property which, with accrued interest, will eventually pay for replacement.

Statute of Frauds  A state law which provides that certain contracts must be in writing in order to be enforceable at law. Examples: real property lease for more than one year; agent’s authorization to sell real estate.

Subject to Mortgage  When a grantee takes title to real property subject to mortgage, he is not responsible to the holder of the promissory note for the payment of any portion of the amount due. The most that he can lose in the event of a foreclosure is his equity in the property.

Subordination Clause  (1) A clause in a junior lien permitting retention of priority for other liens; (2) a clause in a first deed of trust, permitting it to be subordinated to subsequent liens, for example, the liens of construction loans.

Tenancy in Common  Ownership by two or more persons who hold undivided interest, without right of survivorship; interests need not be equal.

Title  Evidence that the owner of land is in lawful possession of it; an instrument evidencing such ownership.

Title Insurance  Insurance written by a title company to protect a property owner against loss if title is imperfect.

Trust Deed  see Deed of Trust.

Trustee  One who holds property in trust for another to secure the performance of an obligation.
**Trustor**  One who deeds his property to a trustee to be held as security until he has performed his obligation to a lender under terms of a deed of trust.

**Usury**  On a loan, claiming a rate of interest greater than that permitted by law.

**Valuation**  Estimated worth or price; the act of valuing by appraisal.

**Vendee**  A purchaser, or buyer.

**Vendor**  A seller, or one who disposes of a thing in consideration of money.

**Waste**  Damage to property by neglect or otherwise.

**Zoning**  Specification by city or county authorities of the type of use to which property may be put in specific areas.
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