Managing the Development Process

Development is distinct from investment in real estate. Many firms and individuals invest in property-buying existing properties and managing them for investment purposes. Investors often incur some risk in leasing and may make minor renovations, but developers usually engage in both the development and the operating phase of the business.

Developers may take on different degrees of ownership and risk. Developers who operate alone and invest only their own money are said to be 100 percent owners/developers. They furnish all the cash equity, accept all the risk and liability, and receive all the benefits. The concept of a 100 percent owner/developer is useful for analyzing development, because if a project does not make economic sense in its entirety (as viewed by someone who has all the risks and rewards), it will not make sense as a joint venture or other form of partnership.

If two or more people are involved in a development project, one or more of them might be considered developers, depending on their positions. No generally accepted definition exists to determine who is a developer and who is not, but a developer can be defined as the person or firm that is actively involved in the development process and takes the risks and receives the rewards of development. An individual firm that receives a commission for performing a service, such as finding tenants or money, is a broker rather than a developer.

Many people involved in a development project may incur risk. An individual who designs, builds, and leases a building for a landowner for a fee is an agent of the owner, but incurs no risk in development. If, however, the fee depends on the project's success, the individual accepts development risk.

Experienced developers are able to transfer risk to others by using other people's money or finding a lender who will give them nonrecourse financing. They still carry the burden of delivering a successful project, however. In most cases, they will have something at risk somewhere along the line, such as front money for feasibility studies, investment in preliminary designs, earnest money, or personal liability on construction financing.

Development companies increasingly serve as development managers for major institutions. In this role, they perform all the normal functions of developers except that they bear no risk. The institution--a bank, an insurance company, a foreign corporation, or a major landowner--bears the risk. The developer works for a fee and usually a percentage of the profits (10 to 20 percent) if the project is successful. Historically, developers have preferred to own real estate rather than to manage it for others, because ownership has enabled them to amass wealth. Nevertheless, major developers increasingly have accepted roles as mangers, either to keep their staffs busy during slow periods or to enter new markets with minimal risk.

Understanding the Stages of Development

At each stage of the development process certain items must be completed before moving to the next stage. For example, before lenders consider a mortgage application, the developer usually must provide conceptual drawings, a boundary survey, title information, information about the site's feasibility, market surveys, personal financial information, and an appraisal. Because different lenders have different requirements for appraisals, however, it may be wise not to order an appraisal until a promising lender has been identified. Otherwise, another appraisal--by someone the lender approves-might be necessary.

The sequence of steps to be taken, and even the steps themselves, changes frequently in development. The rate of change in the development world is one of its major sources of excitement. It also gives beginning developers an even chance with experienced developers, because all developers must adapt to, and keep up with, changing conditions or they will fail.

Financing methods and the sequence of financing steps also change regularly. One major change, for example, occurred in the aftermath of skyrocketing inflation in the early 1980's. Developers traditionally first obtained a commitment for a permanent loan and then used that commitment (the "takeout commitment") to obtain a commitment for a construction loan. When inflation reached double digits, developers suddenly could not obtain takeout commitments. Instead, they went directly to construction lenders, who started giving "miniperm loans"-- five-year loans that covered both the construction period and the operating period. By doing so, lenders and developers gambled that interest rates would change (which they did) within five years. They were also prepared to extend the loans (roll them over into new loans) if they did not. With the credit crunch of the early 1990s, developers have seen a return to traditional permanent takeout commitments, which must be secured before the developers can obtain construction financing.

The development process resembles the construction of a building. The foundation must be level if the walls are to be straight. The frame must be square if the finish is to be attractive. Each step in the process depends on the quality of previous steps. Badly negotiated or written agreements with lenders, contractors, tenants, or professionals will come back to haunt the developer. At best, they will be costly to correct. At worst, they might halt completion or occupancy of the project.

Because each stage depends on the preceding one and because the developer must depend on other people to do much of the work, an adequate monitoring system is essential. A critical path chart can be assembled for each development, showing not only the events that must occur before others can be accomplished, but also how much time each step should take. It also shows which events are on the critical path (those requiring the shortest time) and which events have some slack time. Critical path analysis makes it possible to calculate how much extra it will cost to shorten the path by paying workers overtime or paying extra freight charges to receive materials more quickly.

The early stages of development are especially important, involving many iterations of planning and analysis before the architectural plans and other arrangements are finalized. A common mistake at each phase of analysis is to go into too much detail too soon. For example, obtaining detailed working drawings before a market feasibility study is completed is a waste of money. First, the market study should influence the design. Second, if the market is not as healthy as it appeared, the developer may want to abandon the project.

Projects go through several stages of risk. Risk is defined as the total amount of money that can be lost. During the period in which the developer is making preliminary assessments of the market and site, the risk money typically is limited to what is spent on feasibility studies--analyses of soils, the floodplain, and the market and conceptual design. As soon as the earnest money on the land is committed to the project, then the unrefundable earnest money is also at risk; the money at risk escalates dramatically when the developer closes on the land, pays for financing commitments, or authorizes working drawings. These events should be delayed as long as possible, until the developer can answer as many questions as possible or obtain the best information on which to decide whether or not to proceed with the project.

Analysis of the numbers becomes more detailed and more sophisticated at each iteration. The initial contract for earnest money may require only a simple capitalization analysis to see whether or not land cost yields the desired overall return (net operation income divided by total project cost). Before the earnest money contract becomes final, however, an annual cash-flow proforma is necessary, at least for the operating period. It should reflect the actual square footage planned, projected rents (based on the market analysis), and estimated construction costs. For the next iteration, a monthly cash flow during the construction period is necessary to convince the lender that enough cash will be available to complete the project. It will be based on still more accurate information about costs (from detailed design drawings) and revenues (including rent concessions and tenant improvement allowances). Finally, for a joint venture or equity syndication, a cash-flow statement is necessary that combines both construction and operating periods and illustrates the timing of equity requirements, distributions of cash, tax benefits, and proceeds of sales.

The level of detail should correspond to the quality of information available at each stage. Preparing a monthly spread sheet for 60 months before reasonably accurate construction costs and market data have been assembled is a waste of time and money, yet developers need enough information to make a good decision at each stage. The information should be comparable in quality for all of the different parameters, and it should be as comprehensive as possible for a given level of risk money.

Because each deal has its own distinctive characteristics, limiting risk as much as the developer would like is not always possible. In very hot markets, for example, a "free look" may not be possible and earnest money may be forfeitable from the first day, or the developer might have to close on the land in 60 days, before securing a firm commitment for financing. Two general principles apply: one, recognize that development is an iterative process in which each iteration brings more accurate information and puts a greater amount of money at risk; and two, spend enough money to get the quality of information needed, but do not risk more than is necessary for each level of commitment.

Summary

Real estate development requires many different talents and skills with respect to managing people and managing risk. Development is fundamentally a creative process, and managing creative people and motivating them to do their best work is one of the elements necessary for success. Development involves solving numerous problems. No matter how well planned a project is, unexpected events arise that the developer must overcome.

Founder

Gerald A. Snowden, founder and president, has 20 years experience in the industry. His extensive background includes experience in both landlord and tenant representation, property management, investment sales, office building renovations and commercial development. After a highly successful period at a large national real estate organization as an office-building specialist, Jerry was handpicked by a prominent local developer to start his own company to market over 2 million square feet of speculative office space.

Jerry is a graduate of Oakland University (B.A.). He is a member of the Urban Land Institute and a graduate of the Commercial Real Estate Development Program. Jerry has completed CCIM courses, including Investment Analysis, Marketing, Finance and Taxation.