

# Marketing Transit Oriented Design

## Phase I Final Report

*Part 1: A Profile of the  
Traditional Real  
Estate Development  
Process*

*Part 2: Florida Growth  
Management*

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## Abstract

This document is a review of the current process for real estate development in the State of Florida. The document is divided into two parts:

Part 1: A Profile of the Traditional Real Development Process

Part 2: Florida Growth Management

**Part 1: A Profile of the Traditional Real Development Process:** This part of the document describes the process that developers use to identify, plan, finance, and build real estate projects in Florida. The profile breaks real estate development into eight stages, starting with Project Inception and ending with Property Management and Disposition.

**Part 2: Florida Growth Management :** This part of the document provides an overview of development regulation and environmental management procedures, including land use and transportation planning issues, as governed by FS 163, as well as environmental management issues such as wetlands and endangered species. This section of the document describes the institutional structures and legislation association with development regulation and provides general guidance for meeting the regulatory requirements for land development.

This document was prepared by the Marketing Institute at Florida State University's College of Business. The primary authors for **Part 1: A Profile of the Traditional Real Development Process** were Dr. Dean Gatzlaff and Dr. Stacy Sirmans (Department of Risk Management/ Insurance, Real Estate, and Business Law). The primary authors for **Part 2: Florida Growth Management** were DeWayne Carver and Mark Lippert (Transportation Research, the Marketing Institute.)

# **A Profile of the Traditional Real Estate Development Process**

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# **A Description of the Traditional Real Estate Development Process**

## **1.0 INTRODUCTION**

Real estate development is the process of reshaping, building, and renovating the built environment to provide space and shelter for human activities. In the development process; land, labor, capital, and entrepreneurship are combined to turn an idea into useable space. This process can include the acquisition of land and the installation of site infrastructure (e.g., streets and utilities), to the construction of buildings and other site improvements (e.g., parking and lighting). The term developer describes a person or firm that initiates, organizes, and manages a team of professionals that are involved in some aspect of real estate construction.

While the definition of real estate development remains simple, the activity has become complex. Today, the development process requires more knowledge than ever before about prospective markets and site selection; investment analysis; land use, building, and environmental regulations; conveyances and contracts, building design and construction; financing; property management; and asset management.

Real estate development encompasses a variety of activities that range from the purchase and improvement of raw land to the renovation and re-leasing of existing buildings. As the complexity of the development process has increased, so has the specialization of the participants involved in the process. For example, development teams often include design professionals, engineers, market and financial analysts, contractors, attorneys, sales and leasing associates, and other specialists. As more affiliated professionals have begun to work with developers, the size of the development team has increased and the roles of some of the professionals have changed. Although greater complexity generates the need for more informed developers, it does not change the steps they typically follow in the development process.

The traditional development process can be described as consisting of eight phases: (i) project inception; (ii) preliminary analysis and site selection; (iii) formal due diligence and project feasibility; (iv) contract negotiation; (v) formal commitments; (vi) construction and lease-up; (vii) construction completion and initial occupancy; (viii) project management and disposition. While the specific tasks involved in each phase can differ substantially from project to project, the general phases do not vary significantly. The eight phases of the process are outlined in Exhibit 1-1.

It is important to realize that the process is fluid. At times the tasks of some phases may be completed simultaneously, or out of sequence. Exhibit 1-1 represents a “snapshot” of the process and does not convey the constant reevaluating and repositioning that occurs in the developer’s mind or the nearly constant negotiation that goes on between the developer and all the other participants in the process.

The process of development is dynamic, often very complex, partly logical, and partly intuitive. At every stage, the developer considers the effects, if any, of current decisions on all

of the remaining stages of the process. The development process is inherently interdisciplinary. It is a process that demands attention to all the different aspects influencing the development function—economic, physical, legal, political, or social.

This section of the report consists of ten chapters. The chapters include this introduction, a chapter for each of the eight phases of the development process and an chapter listing addenda.

**Exhibit 1-1**

**The Development Process**

<b>Phase No.</b>	<b>Phase Name</b>	<b>Primary Tasks</b>
<b>I.</b>	Project Inception	<ul style="list-style-type: none"> <li>• Financial, development, and operational objectives determined.</li> <li>• Financial, physical, and legal issues initially considered.</li> <li>• Development team and professionals consulted</li> </ul>
<b>II.</b>	Preliminary Analysis	<ul style="list-style-type: none"> <li>• Preliminary market analysis</li> <li>• Preliminary regulatory review</li> <li>• Preliminary site evaluation and programmatic design</li> <li>• Site control secured (optional)</li> </ul>
<b>III.</b>	Formal Due Diligence and Project Feasibility	<ul style="list-style-type: none"> <li>• Site and environmental evaluation</li> <li>• Market analysis (supply and demand)</li> <li>• Cash flow projections and initial cost estimates</li> <li>• Design development</li> </ul>
<b>IV.</b>	Contract Negotiation	<ul style="list-style-type: none"> <li>• Land assembly</li> <li>• Initial lease commitments</li> <li>• Equity and debt contracts analyzed</li> <li>• Construction documents and cost estimates finalized</li> <li>• Public development approval</li> </ul>
<b>V.</b>	Formal Commitments	<ul style="list-style-type: none"> <li>• Construction loan</li> <li>• Construction permits and approvals</li> <li>• Construction contracts awarded</li> </ul>
<b>VI.</b>	Construction and Lease-up	<ul style="list-style-type: none"> <li>• Lease documents</li> <li>• Construction administration</li> <li>• Construction inspections</li> </ul>
<b>VII.</b>	Construction Completion and Initial Occupancy	<ul style="list-style-type: none"> <li>• Certificate of occupancy</li> <li>• Permanent financing</li> <li>• Pre-opening staffing and marketing program</li> <li>• Tenant move-in and grand opening</li> </ul>
<b>VIII.</b>	Property Management and Disposition	<ul style="list-style-type: none"> <li>• Management agreements</li> <li>• Operating budget</li> <li>• Operations and risk management</li> <li>• Property sale</li> </ul>

**2.0 PHASE I: PROJECT INCEPTION**

The project inception phase is informal and unstructured. In this phase, the developer begins with a set of project ideas, some that may have been considered for some time. In forming this set, developers, as with other entrepreneurs, look to fill an existing or expected market need. Relying largely on their own experience, some of these projects are quickly deemed to be physically impossible, legally impermissible, or not financially feasible by the developer.

## **2.1 *The Three Basic Types of Development Projects***

James Graaskamp (1970) has argued that the types of real estate feasibility analyses conducted can be classified into three areas: (1) a predetermined site, looking for a use; (2) a predetermined use, looking for a site; and (3) funds, looking for an investment opportunity.<sup>1</sup> These can also be viewed as the three basic types of needs that developers seek to address.

### *2.1.1 A Predetermined Site, Looking for a Use*

In this situation, the developer has identified a specific site and searches among alternative possible uses for one that offers the most likely probability of meeting the developer's (and user's) financial return requirements. The fundamental physical and legal characteristics of the site are known; however, the economic environment and the possible users of alternative facilities need to be identified and evaluated.

An example of this type of situation is one which an industrial park is under development and a track of land within the park is vacant. Assume the developer identifies the site as potentially desirable to a number of the users (i.e., ultimate owners or tenants) that he or she has worked with in the past. The developer currently understands the basic criteria that each of the possible users apply to evaluate their new locations. Based on this information, the developer ranks the likelihood of each user's interest, considering the economic environment, and makes initial inquiries. If the users are interested, the analysis progresses to the preliminary analysis phase.

### *2.1.2 A Predetermined Use, Looking for a Site*

In this case, the developer has a specific activity (or use) in mind and is searching for an appropriate site for that use. Under this scenario, it is most often the case that the developer has established an ongoing business relationship with an enterprise that is looking to expand, such as a retail outlet, a restaurant, or some other type of service facility. In this scenario, sites are first identified that meet the location needs (e.g., access, visibility, etc.) of the user and are then evaluated relative to their physical, legal, and environmental characteristics.

Alternatively, the developer may not have a specific user identified. It may be that economic or demographic conditions are such that the demand for a particular use is expected to be strong and the developer hopes to take advantage of this trend by identifying possible sites that fit the trend. One example of this may be the development of assisted-care and senior living facilities.

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<sup>1</sup> Graaskamp, James A. 1970. *A Guide to Feasibility Analysis*. Society of Real Estate Appraisers, Chicago, IL.

### *2.1.3 Investors with Capital, Looking for an Investment Opportunity*

Here the developer wishes to identify the subset of opportunities that fit within a defined investment strategy of the underlying long-term investor. The long-term investor could be a real estate investment trust (REIT), an institutional investor, a pension fund, the developer himself, or some other investment entity. The investment strategy may be formally documented, as in the case of a real estate investment trust, or simply implicitly followed by the investor when conducting business. The strategy can be separated into the following three components: investment philosophies, investment objectives, and investment policies.

The investment philosophies indicate how the long-term investor wishes to participate in the on-going operation of the property. For example, does the investor plan to handle the on-site management of the property or hire a property management consultant. The objectives specify the developer's goals (e.g., build-and-hold versus build-and-sell). The objectives may be viewed as general guidelines for choosing which types of facilities to develop or in which to invest. Finally, the developer's investment policies form the specific constraints used to select among alternative projects (e.g., size, property type, geographic area, holding period).

## **2.2 *Market Considerations.***

In the project inception phase, the developer implicitly considers the trends and levels of important economic factors such as mortgage interest rates, inflation, employment, and per capita income when identifying possible projects. However, no formal financial analysis takes place during this phase.

Micro-market trends in the local area or property sectors are considered for possible niche opportunities. Market niches are defined geographically and by product type. They can be as narrowly defined as, say, an apartment complex that has more two- and three-bedroom units than do other projects in the area or a multi-tenant warehouse building with front-loaded garages. Finding and verifying the existence of special markets generally requires further study. It requires perception, intuition, and information about the market that other competing developers may not possess.

Once a small set of possible projects are identified, the developer begins to consider the framework within which the project is set. These factors typically include the land use and zoning constraints, location advantages and disadvantages, land assembly needs, political considerations, and the environmental requirements necessary to successfully complete such a project.

## **2.3 *Financial Considerations***

Phase I of the development process includes a simple “back-of-the-envelope pro forma”—a simple comparison of value and cost. At this point, a detailed cash flow analysis is not possible because the idea is too preliminary. Because most ideas at this stage never extend beyond preliminary analysis, the developer cannot justify spending a great deal of time fully analyzing the financial aspects at this point in the process.

The financial projection consists of a rough estimate of multiplying the leasable square footage of the project by its expected net annual rent (net of vacancy and operating expenses). The resulting value is then multiplied by a net income multiplier, say 10.<sup>2</sup> This is also defined as the inverse of the overall capitalization rate. This very rough estimate value is compared to an equally rough estimate of the cost.<sup>3</sup> If the value of the project exceeds the cost, the idea is still alive and further analysis is warranted.

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<sup>2</sup> The net income multiplier (NIM) is defined as the value (V) of the project divided by its net operating income (NOI), where the net operating income is the potential gross rent less any rental losses due to vacancies and operating expenses. Hence,  $NIM = V / NOI$ . This can also be defined as the inverse of the capitalization rate (R). The capitalization rate is defined as:  $R = NOI / V$ .

<sup>3</sup> Comparing the value of a project with its cost is defined by some as the Q-ratio. The Q-ratio suggests that in equilibrium the value of a project will equal its cost; hence,  $Q=1$ . If  $Q>1$ , the value of the project is greater than its cost and the condition of the market is considered favorable for new development. If  $Q<1$ , the market is considered currently unfavorable for new development.

### 3.0 PHASE II: PRELIMINARY ANALYSIS

The primary activities of Phase II are (1) the assembly of the development team, (2) the preliminary market and financial analyses, (3) the analysis and selection of the site, and (4) the acquisition of the site development rights.

#### 3.1 *The Development Team*

During the preliminary analysis phase, professional relationships are initiated with the members of the development team. The development team involves various types of business relationships. These relationships can be classified as: (1) those who supply services, materials, and labor, and (2) those who supply financial capital.

**Exhibit 3.1**

<b>The Development Team</b>		
<b>Type</b>	<b>Relation</b>	<b>Major Participants</b>
<b>Investors</b>	Suppliers of Financial Capital	<ul style="list-style-type: none"><li>• Equity Partners (or joint venture partners)</li><li>• Lenders (construction and permanent)</li></ul>
<b>Services</b>	Suppliers of Services, Materials, and Labor	<ul style="list-style-type: none"><li>• Attorneys</li><li>• Design professionals (architects and engineers)</li><li>• General contractor (and subcontractors)</li><li>• Real estate consultants (marketing, management, and financial personnel)</li></ul>

The development team includes the developer's business relationships beyond simply the employee relationships of the developer. In fact, most development companies which do not directly engage in the design or construction of the project typically employ only a small support staff. The development team, however, may include any of the following: equity partners, joint venture partners, lenders, attorneys, architects, engineers, contractors, construction managers, and real estate brokers, leasing agents, managers, and analysts.

Development and construction projects, like other real estate investments, have a financial capital structure usually comprised of part equity and part debt. Developers may contribute some money, but partners or stockholders often provide most of the equity capital. Institutional and individual investors, operating through partnerships, joint ventures, or individually (or indirectly through the REIT ownership form) provide much of the equity capital necessary for the investment in development ventures as well as existing properties.

Joint venture arrangements represent a way of raising equity (and debt) capital. In equity joint ventures, "money" partners supply all funds necessary to advance the project, while the developer supplies the ideas and managerial skills to complete the project. Developers in these arrangements are sometimes referred to as fee developers because their compensation largely comes in the form of fees, rather than from the operation and sale of the property.

In mortgage joint ventures, lenders receive a portion of the rental income and/or the proceeds from the sale, in addition to the mortgage payments. In this case, the mortgage contract rate is set below the current market rate; hence, the mortgage partner exchanges mortgage interest income for equity income. Because of the risk associated with an equity investment is higher than that of a debt investment (i.e., the mortgage loan is typically secured by the property), the equity investor's required returns are substantially higher than those required by mortgage providers.

### **3.2 Preliminary Market and Financial Analyses**

In the preliminary market analysis phase, regional, city, and neighborhood data that are factors in determining the success of the project are gathered and evaluated. Such factors include population and demographic statistics, income statistics, and general economic data (e.g., unemployment rates, inflation, and employment growth). General urban growth patterns, land use patterns, zoning regulations, and environmental issues are initially reviewed.

#### *3.2.1 Market Considerations*

The condition of the market is typically described in terms of the supply of and the demand for space. In phase II, the developer is concerned about having a good general understanding the national (esp., financing terms and national tenant information), regional (esp., demographic and economic information), and local trends (esp., population, economic, and regulatory information). At this level, developers seek to determine the major trends in demand and supply, to identify the investment performance of particular property segments.

Developers follow both fundamental and technical analysis. Fundamental analysis seeks to evaluate the strength of the underlying "fundamental" factors of a property sector's performance and outlook. Technical analysis looks at past trends and cycles in an effort to evaluate whether a particular sector is out of equilibrium (i.e., over- or under-supplied).

Looking first at demand, developers try to be familiar with economists consensus forecasts of the general direction of the U.S. economy. These forecasts often include items such as job growth, income growth, and population growth. These economic characteristics are useful for segmenting markets to project emerging demand for various types of space, such as office, housing, and retail. Macro forecasts are available from several sources and can be used to develop accurate forecasts of local demand. The developer ultimately translates these forecasts into an absorption schedule relevant for the proposed project.

Paralleling the very broad nation examination of demand are a variety of supply considerations. First, developers gather aggregate statistics on the existing supply of the type of space they are considering developing, noting especially the vacancy rates. Aggregate statistics are often available from local planning agencies, independent consulting companies, as well as large real estate brokerage firms. For example, E&Y Kenneth Leventhal publishes an annual real estate market outlook that covers the multi-family housing, retail, office, industrial, and hotel sectors.

Data on the amount of space currently under construction, permitted, and in the approval process are also critical to analyzing the supply in any market. It is particularly useful to survey markets, identify competing projects, and note their performance; and what size and type of “unbuilt” capacity (i.e., developable space) occurs in the area. Only certain locations fit certain needs. Drainage, topography, soil conditions, and infrastructure limitations prohibit development in certain areas.

In addition to having a general understanding of a markets developers also need to acquire a picture of the local legal and political situation. How easy is it to obtain the approvals and permits for a new building? What is the time required to complete a new project? Are there any special regulatory requirements to which the project is subject?

### *3.2.2 Financial Considerations*

Ratio analysis is conducted to offer a preliminary indication of the financial feasibility of the project. Ratio analysis involves a refinement of the back-of-the-envelope analysis conducted in the initial phase of the process. During this phase the developer refines the initial cash flow estimates by consulting real estate brokers, leasing agents, and potential tenants.

The critical question of project solvency is initially approached in this phase. A key part of the analysis is determining how much start-up capital is required and what alternative sources of capital are available. Refined estimates of the cash flows generated from operations—the first year’s net operating income, annual debt service, and before-tax cash flows—are estimated. At this point these estimates assume only that the project is fully operating.<sup>4</sup> The cash flow estimates do not take into account the lease-up period required on a new project. That refinement is saved for the feasibility analysis phase. The elements of the cash flow estimate are identified in Exhibit 3.2.

The potential gross income, PGI, constitutes the total rent to be received if the property is fully occupied. In the above example, we’ve assumed that the PGI was 370,000 (say, 25,000 sq. ft. can be leased at \$14.80 per square foot per year). The vacancy and collection loss, V&CL, represents a reduction in the rent receipts due to expected vacant space over the course of the year. Virtually all projects assume that some percentage of the leasable area will be vacant during the year. Typical average annual vacancy rates may range from 5 to 10 percent for apartment properties to as high as 35 percent for hotel properties. Miscellaneous income, MI, is income that is derived from sources other than the rental of space (e.g., vending, parking, laundry, etc.). Operating expenses, OE, are expenditures incurred by operating the project (e.g., real estate taxes, insurance, property management, utility costs, maintenance, security, etc.). Developers obtain the refined estimate of net operating income, NOI, for the first year by subtracting the expected operating expenses from the property’s expected effective gross income, EGI.

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<sup>4</sup> The expected annual income generated assuming that the property is operating at its average long-run occupancy rate is commonly referred to as the property’s “stabilized” income.

**Exhibit 3.2****Elements of the Cash Flows from Operations**

<b>Operation</b>	<b>Cash Flow Element</b>	<b>Symbol</b>	<b>Example</b>
	Potential Gross Income	PGI	370,000
-	Vacancy and Collection Losses	V&CL	33,300
+	Miscellaneous Income	MI	3,300
=	Effective Gross Income	EGI	340,000
-	Operating Expenses	OE	140,000
=	Net Operating Income	NOI	200,000
-	Debt Service	DS	160,000
=	Before Tax Cash Flow	BTCF	40,000

The annual debt service (annual mortgage payment) allowed by lending institutions can be determined by dividing the property's NOI by the lender's required debt coverage ratio, DCR (the DCR is defined as a project's NOI divided by its DS ( $DCR = NOI / DS$ )). For example, assume the lender has set its maximum allowable DCR at 1.25. If the project generates an NOI of \$200,000, the maximum mortgage payment allowed by the lender is \$160,000 ( $DS = NOI/DCR = 200,000/1.25$ ).

The maximum mortgage amount can then be determined by dividing the allowable mortgage payment by the lender's required mortgage constant, MC. If we assume the mortgage constant is .08, then the maximum mortgage amount is \$2,000,000 ( $\$160,000 / .08 = \$2,000,000$ ). In other words, the \$160,000 annual mortgage payment is sufficient to satisfy the return requirements of the lender who has invested \$2,000,000 in the project.

To determine the maximum amount that equity investors are willing to provide, the before-tax cash flow is estimated first by subtracting the debt service from the net operating income ( $\$200,000 - \$160,000 = \$40,000$ ). Thus, \$40,000 cash is used to satisfy the cash flow from operations requirements (dividend) of the equity investors. If we assume they require a 10 percent dividend, then they cannot invest more than \$400,000 in the project ( $\$40,000 / .10 = \$400,000$ ). Hence, the project's preliminary maximum value to the investors of this project is \$2,400,000 ( $\$2,000,000$  (debt) +  $\$400,000$  (equity)).

Another ratio that is often used as an important investment criterion is the overall capitalization rate, R. This is often referred to as simply the cap rate. The capitalization rate, R, is equal to the NOI of the project divided by its value, V, ( $R = NOI / V$ ). In the example used above the cap rate is 8.33 percent ( $\$200,000 / \$2,400,000$ ). Investors often use target capitalization rates in evaluating and selecting among alternative investments.

### **3.3 Site Analysis and Selection**

In the process of finding a site and determining the proper scope of the project, developers undertake a number of tasks: (i) they analyze the overall market factors significantly

affecting the project—possible competitors, government jurisdictions, and political powers; (ii) they evaluate alternative neighborhoods; (iii) they set the market, physical, legal, and political criteria for site selection; (iv) they identify and evaluate alternative sites; (v) they negotiate for the chosen site and structure a contract to secure the site; (vi) they evaluate the regulatory constraints on the site and their project; (vii) and they begin to form the design program (space and parking requirements) by discussing the physical aspects of the site and project with architects, engineers, land planners, contractors and other development professionals.

### Exhibit 3.3

<b>Primary Site Selection Determinants</b>	
<b>Factor</b>	<b>Issues</b>
<b>Zoning</b>	Legal use of the site; restrictions on density and layout; and adjacent land uses
<b>Physical features</b>	Size; soils; topography; hydrology
<b>Utilities</b>	Sewage; water; electricity; gas; oil; telephone; cable computer lines
<b>Transportation</b>	Modes available; access (ingress and egress); visibility
<b>Parking</b>	Number cars; topography
<b>Environmental impact</b>	Adverse impacts on air, water, and noise levels; other concerns for historic districts, parks, open space, and trees
<b>Government services</b>	Police; fire; garbage collection; schools; health facilities; other government services
<b>Local attitudes</b>	Growth and no growth conditions
<b>Land price</b>	Cost constraints

Source: G. V. Barrett and J. P. Blair, "How to Conduct and Analyze Real Estate Market and Feasibility Studies," 1982.

The preliminary analysis phase concludes with the developer obtaining control of the site. The most popular arrangements for acquiring development rights include option contracts, contracts for sale with contingencies, binders, and letters of intent. Option contracts and contracts for sale with contingencies tie up properties for specified period in return for the payments of fees—the option price or an earnest-money deposit with contingency contracts. Binders require deposits in exchange for rights of first refusal. Letters of intent do not secure properties. Owners may sell properties while developers are studying market feasibility or trying to obtain financing.

**Exhibit 3.4**

**Alternative Contract Arrangements for Acquiring Control of the Site**

<b>Contract</b>	<b>Action</b>	<b>Security of Development Rights</b>	<b>Expense</b>
<b>Option</b>	Developer buys right to purchase property at set price over specified period	Excellent, property owner cannot sell to others	High—one to three percent of property price
<b>Contract for sale with contingencies</b>	Developer makes offer contingent upon certain events occurring	Excellent, if property owner accepts offer, but not generally successful in active markets	Low—only an earnest money deposit
<b>Binder</b>	Developer buys a right of first refusal from property owner	Good, but does not prevent property owner from selling to others	Low to medium depending on obligation to the developer
<b>Letter of intent</b>	Developer issues letter demonstrating intent to buy property from owner	Poor, but developer may obtain free right of first refusal	Zero

Source: J. Corgel, H. Smith, and D. Ling, "Real Estate Perspectives," 1998.

## 4.0 PHASE III: FORMAL DUE DILIGENCE & PROJECT FEASIBILITY

The purpose of this phase is to determine (1) if the expected cash flows from the project are adequate to meet the investors' overall required rate of return, (2) the physical requirements (space, parking, and off-site requirements) and their associated costs, and (3) the environmental constraints necessary to proceed with development.

### 4.1 *Financial Considerations*

The feasibility study, whether formal or informal, addresses the question of whether the project's operating income will be adequate to meet the investors' (debt and equity) required rate of return. For a proposed development or redevelopment, the feasibility study analyzes the relationship between the expected cash flows (from operations and sale) and the development costs.

#### 4.1.1 *The Feasibility Analysis*

The formal feasibility study consists of the two major components: (1) a market analysis, and (2) a financial analysis. The market analysis generally consists of:

*The regional and city analysis:* The principal types of information included in the regional and city analysis are the growth trends in economic, demographic, social, legal and environmental variables. In addition, an overview of the physical, legal, environmental, and political constraints is provided in this section of the report.

*Neighborhood and site data:* The physical, legal, environmental, and political constraints associated with developing a particular project on a specific site (or group of alternative sites) are reported in this section of the report. Most of the data reported bear on the physical possibility of constructing a building on the site. Data are reported on the topography, drainage, soil composition, utilities, easements, zoning, setback requirements and other conditions relevant to the construction process.

*Project market analysis:* This section explains the market conditions for the type of project being considered. It includes an analysis of demand and supply. The demand analysis evaluates the factors that will affect selling or leasing the project, such as population growth, employment growth, and income growth. The demand analysis portion of this report section concludes with an estimate of the type of space demanded and the market's expected absorption rate.<sup>5</sup>

The analysis of supply represents one of the most difficult, and important, sections of the report to complete. It involves an examination of the current and expected future supply of space directly and indirectly competing with the project. Typically, this involves obtaining

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<sup>5</sup> The absorption rate can be defined as the amount of space (units) that is newly occupied each period (e.g., year or month). For example, the absorption rate for retail space for a market sector and area could be stated as 100,000 square feet per year.

survey (or census) information from the local planning department which outlines the amount of space, occupied and unoccupied, that currently exists in a particular market area. In addition, any new developments being planned are identified and evaluated. Finally, the project's major competitors are identified and evaluated with respect to their competitive advantages and disadvantages. The supply analysis portion of the report concludes with an estimate of the expected market rental rates and expected vacancy rates.

The financial analysis section of the report generally consists of:

*An estimate of the cash flows from operations and sale:* The market analysis provides the necessary inputs for projecting the expected cash flows from the proposed development for the expected holding period. Generally, the cash flow estimates are constructed for seven- to ten-year holding periods. Estimation of the expected cash flows requires consideration of the development (construction) costs, rents, vacancies, other sources of income, operating expenses, and financing arrangements. If the specific investor is known, the analysis should be done on an after-tax cash flow basis.

A simple example of a cash flow projection, using the first year's cash flow assumptions presented in Exhibit 3.2 above, is presented in Exhibit 4.1. It assumes that rents (PGI) will increase at 2.5 percent per year, the vacancy rates will decrease from the current nine percent, to eight percent in Yr. 2, and seven percent in each year thereafter. Miscellaneous income from other sources is expected to increase at 2.5 percent per year. Expenses are expected to remain at approximately 41.1 percent of the EGI and the debt service is constant (i.e., fixed-rate permanent mortgage financing is assumed).

**Exhibit 4.1**

<b>Expected Cash Flows from Operations (five-year holding period)</b>						
	<b>Element</b>	<b>Yr. 1</b>	<b>Yr. 2</b>	<b>Yr. 3</b>	<b>Yr. 4</b>	<b>Yr. 5</b>
	PGI	370,000	379,250	388,731	398,450	408,411
-	V&CL	33,300	30,340	27,211	27,892	28,589
+	MI	3,300	3,383	3,467	3,554	3,643
=	EGI	340,000	352,293	364,987	374,112	383,465
-	OE	140,000	145,062	150,289	154,046	157,897
=	NOI	200,000	207,231	214,698	220,066	225,568
-	DS	160,000	160,000	160,000	160,000	160,000
=	BTCF	40,000	47,231	54,698	60,066	65,568

*An estimate of the expected investment returns and investment value:* This section of the report will include computation of the present value of the expected cash flows, the net present value of the investment, and its internal rate of return. In addition, the investment ratios, such as the operating expense ratio, the break-even ratio, the cash-on-cash return, the debt coverage ratio are generally reported.

As an example, assume further the following for the project outlined in Exhibit 4.1: the project is expected to be worth (sell for) approximately \$2.75 million at the end of Yr. 5, the balance on the loan is \$1.9 million at the end of Yr. 5, and selling expenses are \$200,000. The proceeds from the sale at the end of Yr. 5 to the equity investor are then \$650,000.

If the equity investor's overall required rate of return is 15 percent, the financial returns of this project can be easily determined. The value of the debt position (mortgage loan amount) was previously determined to be \$2,000,000. Using updated information and projections, the value of the equity investor's position is identified as the present value of the expected BTCFs (discounted at the equity investor's required rate of return of 15 percent). Hence, the value of the equity position is \$496,568. Adding this value to the value of the debt yields a total project value of \$2,496,568. If the present value of the development (or purchase) costs of the project are less than \$2,496,568, then the project is deemed to be financially feasible (will return the equity investor more than a 15 percent return).

If the estimated development (or purchase) costs of the project outlined in Exhibit 4.1 are assumed to be \$2.2 million,<sup>6</sup> then the net present value of the development is \$296,568 (\$2,496,568-\$2,200,000). In addition, the internal rate of return (the discount rate at which the net present value equals zero) is often determined and evaluated.<sup>7</sup>

*Sensitivity analysis:* Sensitivity analysis is often conducted to evaluate the risk associated with various cash flow assumptions. In this section, the major assumptions, such as the vacancy rate, the lease-up period, or the financing terms, may be varied and the investment decision criteria reevaluated under these alternative scenarios.

#### **4.2 Environmental Considerations**

If the project is deemed financially feasible and the site is secured, an environmental audit is generally required. Three types of environmental value assessments may be needed. A Phase I EVA is based largely on a sampling of air and water sources, a search of the property records, and a visual inspection of the property. It seeks to determine whether there is a reasonable basis to suspect the presence of an environmental concern and whether there are environmental restrictions on the use of the property.

A Phase II EVA is required when a Phase I report reveals the presence of significant amounts of toxic waste. It involves substantial testing and seeks to determine to a reasonable degree of scientific certainty whether a suspected environmental risk is or is not present.

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<sup>6</sup> For simplification, we have assumed that all development (investment) expenditures will occur in today. In reality, the expenditures would occur during the development period. The timing of the actual cash flows would need to be considered in the financial analysis.

<sup>7</sup> It is important to note that apply the net present value investment decision criterion of  $NPV > 0$  is preferred to using the internal rate of return.

If the Phase II EVA finds an environmental risk, a Phase III EVA becomes necessary. The Phase III EVA attempts to quantify the environmental risk, develop a remediation plan, and determine the approved and restricted uses for the property.

#### **4.3 *Physical Considerations***

In this phase of the development process, architectural and engineering design development proceeds on the project. This entails the refinement of the project's space requirements, building layout, zoning approval, and building code review. During the design development phase of the project, the architects, engineers, and other design professionals determine the developer's design objectives and conform them to the regulatory and structural requirements of the project. In most cases, refined cost estimates are produced by either the contractors, architects, engineers, or a professional cost estimating service at the end of this phase.

At the end of the design development phase, and assuming other aspects of the project indicate moving toward the construction contract phase, the developer gives the architects and engineers approval to begin construction documents. The construction documents typically include the finished architectural, structural, mechanical, plumbing, and HVAC drawings (additional construction drawings may be required for some projects) and their accompanying specifications. These documents inform the contractor precisely how to construct the project, the construction standards and the materials to be used.

#### **4.4 *Regulatory considerations***

Site plan documents, typically a part of the design development phase, are generally submitted for land use and zoning approval as during of this phase. In many cases building construction documents are submitted for preliminary approval and compliance reviews to the local building, health, and environmental codes.

## **5.0 PHASE IV: CONTRACT NEGOTIATION AND PRE-LEASING**

### **5.1 *Introduction***

The previous stage, feasibility analysis, serves as a valuable negotiating tool for stages four and five: contract negotiation and contract execution. Throughout the development process there is constant interaction between various parties. The contract stages cement these relationships into written contracts and agreements. It is essentially the last opportunity for a participant to withdraw from the process before major construction costs are incurred. Establishing definite rules between the parties is critical since they set the basis for the various activities to be performed: physical, financial, marketing, opening and operation.

Real estate development is a physical process - improving land and constructing buildings. The project must be carefully planned and designed. An essential element of this is to have the proper agreements in place. The contract stages confirm that the idea which was shown to be feasible in the previous stage can actually be accomplished by various parties with clearly defined tasks and responsibilities.

It is important that the rules of the game be correctly defined, thus a detailed agreement should be negotiated with each member of the development team. If all contracts are properly written and in agreement, the overall risk for the management team is reduced. The developer must insure that the roles of the various team members are clearly defined and consistent since many of the contracts are contingent on each other. The contracts will provide a clear definition of the rights and responsibilities of participants so that they can become a cohesive group to accomplish the development task.

The contracts are a set of interactive agreements. Simultaneously with establishing a contract with the contractor, the developer must also be concerned with financing agreements (both permanent and construction), equity contracts with partners or equity investors, and marketing contracts with tenants. The developer must also address concerns of governments regarding issues such as environment and impact on congestion, pollution, etc.

### **5.2 *Financing Agreements***

The developer will generally arrange financing by first obtaining a commitment for permanent financing and then securing a construction loan. The previously completed market study and feasibility analysis are generally included in each loan application. The financing needs depend on the strategy pursued by the developer. Developers' strategies can be categorized in three general ways: (1) the developer plans to own and manage the property after completion, (2) the developer plans to sell the project after the lease-up phase (usually sold to institutional investors), and (3) the developer plans to develop land and buildings for lease in a master-plan development (such as build-to-suit).

### *5.2.1 Permanent Financing*

Since permanent financing is usually long-term, permanent lenders are especially interested in the market analysis contained in the feasibility study. The financing they provide may have a life of twenty to thirty years, thus lenders are very interested in understanding the ability of this property to meet demand over a long term.

Most lenders will begin by reconciling the developer's feasibility study to their own perceptions of the market. Lenders may maintain a data base for such a purpose. Experience can allow permanent lenders to examine and anticipate the market potential of a project. Data analysis combined with experience can also help evaluate how well a project fits with anticipated market needs and if it conforms to local design and construction requirements.

Participation in the local market may also allow permanent lenders to recognize competitors of the proposed project. Existing projects, comparable projects under construction, and potential future projects must all be considered when judging the success of the proposed project.

Permanent lenders recognize that the success of a project can depend on the developer's experience and ability to provide services such as management or marketing. More developer experience in the areas of development and management increases the chances that the project will be successful.

Another important consideration for the permanent lender (which may have little to do with the developer) is whether the project fits into the lender's portfolio.

Assuming that the lender feels the project is feasible and that it fits into an overall investment strategy, an agreement on permanent financing is reached. This agreement is a commitment for the permanent loan. It is a contract and its structure is determined by the terms agreed upon by lender and borrower. The final terms will depend on the bargaining strength of the parties. A lender with the upper hand, for example, may write itself a more liberal escape policy should market conditions change. A developer in greater control would prefer to have fixed commitments on interest rates, etc. and a commitment to make the loan regardless of market conditions. The final terms are based on negotiation and will usually be somewhere between the two extremes. Generally, the agreement calls for the loan to be made within a certain time, usually 12 to 18 months in the future. The agreement will also stipulate the terms of the loan such as the loan amount and the repayment scheme. It will, of course, be contingent on successful completion of the project in accordance with the specifications in the feasibility study.

### *5.2.2 The Construction Loan*

Construction financing is usually obtained after the commitment for permanent financing. The construction loan may be provided by a different lender and involves a different set of risks. Construction lenders do not face the market risks or long-term obstacles of permanent lenders. A takeout commitment insures the construction lender that the construction loan will be paid within a certain time. Rather, the construction lender faces the risk that the project will not be

completed on time and within budget. Thus, a major concern for the construction lender is whether the developer can construct the project as planned.

As a result, construction lenders tend to focus on the developer's experience and reputation. The reputation and quality of the general contractor and the architect are also major concerns. The lender looks carefully at the complexity of the project in relation to the experience of the developer since a bad combination of these two can mean disaster for the project.

Construction loans are usually written at variable interest rates. The degree of variability depends on negotiation between the lender and developer. To the extent they can, lenders tend to match their assets and liabilities. Since construction loans are short-term, they tend to be made by lenders with short-term liabilities. Commercial banks are the leading construction lenders.

### **5.3 *Decisions About Project Design and Contractors***

#### **5.3.1 *Contracting with the Architect***

Going into the contract negotiation phase, the developer will thus far likely have relied on preliminary drawings. It is now time to finalize the agreement with the architect and other parties such as engineers. A formal contract should be in place before the architect draws the final plans. It is advantageous if the developer has some understanding of the planning and design process. In the negotiation process, there should be detailed drawings and materials specifications from which construction cost estimates are finalized. Once an agreement is reached, a full set of working drawings and specifications for all items of work is reproduced in contract document form. Once the contract documents have been completed, the construction process can begin. Construction is generally classified by the type of material used for structural support: wood, masonry, concrete, steel, or various combinations of these materials.

A standard contract in the industry is the American Institute of Architects' (AIA) standard contract. Since its redesign in 1987, developers have been careful to execute the contract with all risks and responsibilities clearly defined. Also, lenders sometimes require changes or revisions. For example, lenders generally require an architect to be clearly responsible for all design work so as to insure quality. This means that the developer's contract with the architect may be interrelated with the contract with the lender.

Since the AIA standard contract was written by the AIA, developers must be careful in negotiating the terms of the contract. The contract basically gives the architect control of everything with very little responsibility. For example, all budgeting is listed as additional services which must be paid as extras. If the developer wants additional services besides the architectural design such as interior layout or public hearings, there should be agreement as to payment for these. Since the current version of the contract does not include insurance for errors and omissions. The contract should make clear who will obtain the insurance and who will pay for it.

The standard contract specifies that the plans that are drawn belong to the architect and not the developer even though the developer has paid for them. The contract also requires the owner to hire a geotechnical engineer. While this is appropriate when there is a possibility of hazardous waste, the developer may not need one on every job. The developer may want to revise provisions such as these.

### 5.3.2 *Contracting with the General Contractor*

The contract with the general contractor is generally reached through a bidding process or negotiation of a “cost plus” contract. With bidding, the developer provides plans and specifications to qualified builders and asks for a set price or a base price with additions for certain items that cannot be priced in advance. In a cost-plus arrangement, the contractor agrees to a contract which pays the cost of construction plus an agreeable profit margin.

A critical element of all contracts (even the cost-plus) is the proper estimation of costs in advance. The first step is to break down the proposed project into its various components and determine which will be undertaken directly by the contractor’s own crews and which will be subcontracted. The physical quantity of each component (e.g. hours, square feet, linear feet) is established from the plans and specifications. In all cases, the unit costs should be adjusted for projected changes material prices, changes in labor contracts, the geographical location of the project and the time of year when the project will be undertaken.

In general, developers prefer the fixed-price contract while contractors prefer a cost-plus arrangement. The final contract may be a mix of the two methods. For example, the contract may call for the developer and contractor to share certain costs over a given amount. Alternatively, they may agree to share any profit generated by bringing the project in under cost.

Although the feasibility study gives a fairly clear picture of the proposed project, there is always a degree of uncertainty. The bidding process is most common in projects where the contract is tightly written and there are few change orders. Government contracts are an example.

The complication for the general contractor in the bid method is obtaining reliable cost estimates from subcontractors. All information must then be compiled and submitted to the developer. This may take considerable time and resources for a task where the outcome is quite uncertain.

In selecting a general contractor, local experience can be important. When possible, the contractor should have experience building in the local area. There can be significant differences in building codes, labor relations and practices, and materials purchasing practices between different areas. The financial condition of the contractor should also be considered. The developer may require a financial statement from the contractor. An ideal financial statement would show consistent profitability (indicating good costs control), a good liquidity ratio (indicating sufficient cash to handle day-to-day operations), and no excessive short-term debt.

The developer may also consider subcontractor relations and obtain a list of subcontractors from the contractor.

When a general contractor is selected, contracts are formulated. The typical procedure is to have one contract between the developer and the general contractor and then a series of contracts between the general contractor and the subcontractors. A developer who has established relationships with certain subcontractors may specify to the general contractor that they be used. Developers may negotiate directly with subcontractors if this is felt to be critical to the success of the project. This can sometimes make the general contractor's job easier by establishing a certain subcontractor for a certain task at a given price. Since there are no set rules, the developer should be careful to use the correct system to structure a suitable contract.

### *5.3.3 Fast-Track Construction*

Fast-track construction may be useful when market forces dictate rapid completion of a project. The objective is to have as many construction steps as possible under way at the same time. Coordination is the key to success and contractors are usually operating on a cost-plus contract.

### *5.3.4 Bonding*

It is common for developers and general contractors to be bonded. For example, a local government requiring the developer to provide a bond would insure that the developer has the resources to complete the project. Likewise, the developer may require the general contractor to be bonded to ensure that the contractor has the resources to complete the task. A bond provides the developer or contractor the backing of an insurance company in the event of a dispute or lawsuit. Contracts with the government (federal, state, local) generally require the general contractor to be bonded.

Bonds may take several forms. A completion bond, for example, insures that the project will be completed according to the plans at a given cost. Rarely do insurance companies guarantee that the project will be completed within a certain time.

A performance bond, on the other hand, means that the contractor is backed by the insurance company. In the event of a judgment against the contractor, the insurance company pays the liability. A performance bond guarantees the owner that the surety company will see the job through to completion, regardless of what happens to the general contractor.

## **5.4 *Environmental Concerns in Development***

Environmental concerns today often play a major role in the ability to develop certain lands. Developers must be very careful to verify any restrictions because of such things as hazardous waste or wetlands. Good examples of federal environmental laws which have significantly affected real estate development are the Superfund and the Clean Water Act.

### **5.4.1 *Hazardous Waste***

Congress enacted the Comprehensive Environmental Response, Cleanup, and Liability Act (CERCLA) (a.k.a. Superfund) in 1980. The purpose is to clean up toxic waste sites. Under Superfund rules, current and past owners of contaminated property can be liable for the cost of cleanup. Historically, mere ownership has been sufficient to establish liability even if the hazardous material was dumped legally by someone previously and even if the owner did not know of the contamination. As a result of these all-inclusive rules, lenders will generally not approve a development loan unless the property receives a clean bill of health.

The Superfund Amendments and Reauthorization Act of 1986 (SARA) created a defense for innocent landowners who did not know and had no reason to know that purchased property was contaminated. To be deemed innocent, the purchaser must show “due diligence,” i.e., be able to prove that all appropriate inquiries were made into previous uses of the property to uncover any possible evidence of contamination. Along with federal guidelines, many states have enacted laws to clean up hazardous waste sites.

The main safeguard used by developers is to conduct a Phase I environmental audit that includes at least a background check on previous owners and uses of the property and a visual inspection of the site.

#### 5.4.2 *Asbestos*

Until the 1970s and especially in the 1950s and 1960s, asbestos was used extensively to insulate, fireproof, and soundproof commercial and industrial buildings. In some cases, building codes required the use of asbestos. In the 1970s, however, as mounting evidence exposed the health risks of asbestos, its use was banned. However, EPA estimates show that well over a half million buildings contained asbestos.

Asbestos is a natural fibrous material which poses a serious health risk when it becomes airborne. As it dries, asbestos becomes dry and brittle and dust-like fibers can be released into the air. When inhaled, these fibers lodge in the lungs and can cause asbestosis and lung cancer. This potential problem is capitalized into the prices that investors are willing to pay for properties and has caused lenders to become wary of making loans on buildings containing asbestos.

Congress enacted the Asbestos Hazard Emergency Response Act (AHERA) in 1986 to combat the problem in public schools. However, federal law does not require commercial properties to do anything about the presence of asbestos except that the asbestos must be removed before a building is demolished. Widespread removal of asbestos tends to be very expensive.

The effects of asbestos continue to be a sensitive issue. The January 9, 1998 issue of the *Wall Street Journal* reports that asbestos interests are now looking to Congress for a tobacco-like settlement to end lawsuits. They are pushing for legislation imposing a settlement in the thousands of lawsuits against industry giants such as Westinghouse Electric, Kaiser Aluminum and Chemical, and Georgia-Pacific. The bill would reconsider a \$1.3 billion

settlement that the Supreme Court rejected in the summer of 1997. The proposal would exclude those who were simply exposed to asbestos and limit compensation to persons with actual health problems. A quasi-government Asbestos Resolution Corporation would carry out the settlement.

#### *5.4.3 Wetlands*

Historically, wetlands were not recognized as having any environmental importance. Economically they were considered worthless and developers were encouraged to (and actually subsidized in some cases) convert these to productive uses. Today, however, there is much greater recognition and appreciation of wetlands' place in the environment as natural ecosystems. At least half the states in the U.S. have laws protecting wetlands.

This recognition has prompted the enactment of federal and state laws to protect natural wetlands. Permission to build in wetlands must be granted from the U.S. Army Corps of Engineers. Any adverse impact of development must be mitigated by the developer. The developer must also demonstrate that, for non-water dependent uses, no usable nonwetland sites exist. Developers are sometimes required to compensate for lost wetlands by creating a wetlands site nearby (called wetland mitigation).

Wetland mitigation is controversial since wetlands are complex ecosystems and are difficult to duplicate. Some environmentalists refuse to accept manmade wetlands for natural ones. Experience shows that some wetlands such as tidal marshes can be successfully created while others such as bogs are much more difficult. This has caused regulators to err against disturbing an existing wetland. Plus there is currently more pressure from citizens' groups and other activists to save wetlands, trees, and other natural amenities. Environmental impact studies are becoming commonplace for developers.

### **5.5 *Marketing Contracts***

From the outset, the developer has had some idea of the tenant mix and the major tenants in his project. It is now time to finalize the allocation of space and to set the final contracts. At this point, the developer must decide whether it is better to procure tenants using in-house staff resources or to contract with outside consultants. For some projects, it may be preferable to use outside leasing agents. For specialized areas, the developer may prefer to have the in-house ability to market the project and more closely monitor progress.

Anchor tenants are the critical element. These may be large department stores in a mall or a major tenant occupying significant space in an office building. Anchor tenants know their importance and their bargaining power. Although anchor tenants may require considerable rent concessions, they do attract other tenants. The presence of favorable anchor tenants is usually the key in signing smaller tenants. Anchor tenants may also be a significant factor in obtaining permission and/or financing to carry out the project.

A critical decision by the developer is how much space to allocate to the major tenants. Since this space earns lower net rents (or maybe no rent at all), the profitability of the project is

affected. The developer must consider the proper tradeoff between lower net rents for anchor tenants and the increased demand from the advertising and name recognition of the major tenants.

Although procuring tenants is crucial, when the tenants are signed is just as important. The earlier tenants are signed, generally the more concessions have to be made. In order for tenants to sign early and commit to something that physically doesn't exist, they may require concessions in the form of price or location.

Developers gain certain advantages from having tenants sign early. A high occupancy rate makes the project more attractive at completion. The developer still has to be concerned, however, since higher occupancy has been traded off with concessions which can have real costs. The developer will be interested in the effect on net revenue and profitability.

Signing tenants makes the building process more complex since now the developer has to reconcile tenant needs and desires with the building specifications. For example, what trade fixtures or design does the tenant need and who pays for these? The developer may give tenants allowances and if the cost exceeds this, the tenant pays the additional cost. Or, the tenant may be willing to pay for additional upgrades.

Lenders get into this act since tenant allowances may be negotiated in the first lien and passed along to tenants. This is easier than requiring the tenant to borrow for improvements since the improvements cannot be used by the tenant as collateral. Lenders also gain by having tenants do upgrades since the improvements create additional collateral.

A second aspect of tenant leases is the sharing of operating expenses. This affects the ongoing operations of the project. For example, janitorial issues such as who cleans what and how often can affect the attractiveness of the building. Other issues such as who provides and pays for security and the location of elevators must also be resolved.

A third aspect of tenant leases is agreement on hours of operation and the sharing of costs in joint promotions.

The final agreements reached by the developer and tenants are determined primarily by the market. The optimal position for the developer would be high rents with most expenses paid by the tenant. But, competitive or overbuilt markets can force a different picture. The developer may find himself facing stiff competition and may be forced to make concessions in various areas in order to attract tenants.

## ***5.6 Equity Agreements***

Real estate projects have two basic sources of financing: debt and equity. Lenders rarely loan one hundred percent of the cost of a project thus some equity investment is required. The amount of the loan relative to the value of the project is called the loan-to-value ratio. This ratio is the major way in which lenders regulate default risk. Experience tells them that the more

equity the investor has in the project, the less the risk of default. First, the investor stands to lose the equity investment and second, the property can suffer greater declines in value before the equity is wiped out.

The difference between the value of a project and the amount that can be debt-financed is the equity. Debt financing will normally range from 60% to 80%. In periods such as the early 1990s, having suffered substantial losses in the 1980s, lenders became very conservative and loan-to-value ratios rarely exceeded 75%. In any case, once the amount of debt is determined, the developer becomes responsible for the difference.

In some cases, the developer has the financial strength to provide the required equity. When this is not the case, additional sources of capital must be located. Basically, the developer faces three choices: provide all the necessary equity capital himself, bring in outside investors, or create a joint venture with a lender. In the first case, the developer must have the funds to cover all construction costs above the loan amount plus have funds for leasing period reserves and contingencies.

If the developer lacks the resources or the incentive to do this, outside investors are sought. Current tax laws affecting real estate do not provide as much incentive for investors to pursue real estate investment as did the more-liberal tax laws of the early 1980s. The Tax Act of 1986 eliminated major tax shelter benefits (especially accelerated depreciation and capital gains exclusion) of real estate investment. Congress in 1997 re-enacted a favorable long-term capital gains rate (maximum of 20%).

Developers can sometimes enter into participation agreements with lenders. This means that, along with the normal interest on debt, the lender also “participates” in the profits from the sale of the property at completion. This can be beneficial to the developer if the lender is willing to provide funds at the outset thereby reducing the amount the developer needs. Experienced lenders will know how to use participation to negotiate the most favorable terms for themselves. Developers must decide when to involve outside investors. Profitability is reduced along with the risk exposure for the developer. Alternatively, under certain market conditions, the developer may fare better by funding the entire equity investment himself.

The mix of debt and equity can have an effect on the profitability of the project for the developer. The developer should have experience in discounted cash flow analysis so that sensitivity analysis can be done to determine the optimal capital structure.

### ***5.7 Relationship with the Government***

While the developer is settling on contracts with the architect, the general contractor, the lender, and outside equity investors, relationships with governments (especially local) must also be established. The permits required by the city or county are forms of contracts and will set the stage for how development will proceed.

## **6.0 PHASE V: FORMAL COMMITMENTS**

Some of the contracts which have been negotiated in stage five are contingent on each other. The construction lender's agreement may be contingent on securing permanent financing. The permanent lender's agreement may be contingent on commitments by major tenants. The general contractor's agreement may be contingent on having funds available. Agreements with major tenants may be contingent on assurances that resources are available to complete the project.

Thus, different contracts are reviewed by different parties who aren't necessary direct participants but have a vested interest in the contract terms. Once the parties are in agreement, the contracts are executed. Accompanying the signing of the contracts with the permanent and construction lenders will generally be the payment of commitment fees, origination fees, etc. The execution of the contract with the general contractor is generally followed by the signing of a series of contracts with subcontractors.

In closing on the construction loan, the developer will likely have to close on the land purchase by executing a contract for sale or exercising an existing option to buy the land. In some cases where the land has already been purchased, construction funds may be used to pay off any existing loans. This will insure that the construction lender holds the first lien (which is usually required) on the property. The developer will also be involved in satisfying other requirements such as acquiring liability and fire insurance and establishing a formal accounting system.

Pre-leased space will require formal lease agreements to be signed and recorded. If outside sales or leasing agents are going to be used, formal listing agreements must be executed.

If outside investors are involved, an agreement must be signed. This will usually be a limited partnership agreement. A limited partnership will limit the liability exposure of the limited partners while establishing the general contractor as the general partner.

If possible, building permits were acquired (or at least applied for) in stage four. However, if negotiations in stage five have caused changes in design, construction, etc., it may be necessary to renegotiate with the city/county. Impact fees must be paid and other agreements such as environmental impact studies must be finalized.

Thus, at this point, the developer has negotiated (stage five) and put into place (stage six) the formal agreements necessary to carry the project to a successful conclusion. Up to this point, it has been possible for the developer to stop the process if the project became not feasible. However, executing formal agreements puts the developer past the point of no return. The project could still be stopped but the developer may have built up substantial overhead costs.

## **6.1 *Financing Commercial Real Estate Development***

### **6.1.1 *Debt Financing of Real Estate Properties***

The estimated value of real estate in the U.S. for 1997 was six trillion dollars. At the beginning of 1997, \$4.7 trillion of this was financed with mortgage debt. In 1997, construction loans totaled \$107 billion. The primary originators of real estate debt financing are commercial banks, thrifts, and mortgage bankers. A primary source of funds for real estate financing is life insurance companies. The bulk of construction activity is financed by commercial banks.

Commercial banks have also been the largest source of commercial real estate debt. They hold 50.2 percent of all nonresidential, long-term commercial real estate debt. Life insurance companies have the largest concentration of commercial loans in their portfolios. For 1997, life insurance companies held 24.6 percent of all commercial mortgage loans outstanding in that year. Thrifts continue to specialize in residential properties; however, since deregulation in the 1980s, their holdings of commercial mortgages have steadily increased. In 1997, thrifts held 7.2 percent of all nonresidential commercial property debt.

Institutions invest in real estate debt securities either by lending funds directly or by purchasing debt obligations from another originator. Commercial banks and thrifts currently sell off much of the debt they originate. Historically, life insurance companies have purchased very few debt securities. In 1997, they originated 99 percent of their gross acquisition of commercial real estate debt. Mortgage bankers, as expected, sold off most of their originations in 1997.

Some funds for real estate financing are provided by institutions that purchase mortgage-related securities. These institutions are primarily life insurance companies and pension funds which purchase securities such as collateralized mortgage obligations. Commercial collateralized mortgage obligations were introduced to provide liquidity through a secondary market outlet. Commercial CMOs are considered more risky than residential CMOs since they lack mortgage insurance and the mix of mortgages on various properties may prevent a thorough analysis of the risk of the underlying properties.

### **6.1.2 *Equity Financing of Real Estate Properties***

Investors can hold equity positions in commercial real estate either through direct investment or through securities. With direct investment, institutional and individual investors purchase the property. With indirect investment, investors purchase equity securities. The two most popular types of securities are real estate limited partnerships (RELPs) and real estate investment trusts (REITs). RELPs are of three types: public real estate partnerships, identified private real estate partnerships, and master limited partnerships. Tax law changes in the 1980s reduced the popularity of RELPs. The popularity of REITs, however, has filled the gap. A REIT is a corporation which invests funds raised by selling shares of stock in real estate. REITs enjoy some tax advantages (such as no income taxation) as long as they meet certain requirements.

The two primary institutional investors in equity real estate are life insurance companies and pension funds. Mortgages by far represent the majority of real estate holdings of life insurance companies with equity representing a smaller proportion. The proportion of their total equity real estate assets has held steady at about three percent for the last twenty years. By comparison, they held \$246,702 million in mortgages in 1992. This amounted to about twenty percent of their total assets. The role of life insurance companies in financing equity real estate has been limited due to concern regarding its liquidity. Their primary role has been to provide debt financing.

The growth of pension funds has been phenomenal. In 1970 they held about \$135 billion in assets. In 1991 their assets had increased to \$2.5 trillion. They have only recently developed an interest in real estate as an investment. Pension funds grew gradually more interested in real estate over the 1980s such that, in 1990, equity real estate made up about five percent of their assets. Future pension fund investment in real estate is optimistic as pension fund managers become more aware of portfolio theory and diversification benefits. Changes in the method of reporting pension fund liabilities also encourage pension fund investment in equity real estate.

Public funds are also a source of financing for real estate investment and development. In public/private partnerships, the local government may provide land and/or money. Local governments usually subsidize development by contributing land, providing cash subsidies, and/or providing low interest rate loans. The major benefit to the local government is the filling of a need. This may result in additional property taxes, increased property values, or other benefits.

For real estate developers who have no permanent sources of financing, income property financing source books are available which list lenders and investors interested in investing in real estate. One example is the *Fleets Guide*.

### 6.1.3 Acquisition, Development, and Construction Financing

Nonpermanent financing can be divided into three stages: acquisition, development, and construction (ADC). When the ADC process is financed in stages (as is usually the case), the different lenders will require a detailed set of required provisions for the borrower and the other lenders. For example, a lender who makes a development loan may require that a construction loan be in place before funds are advanced.

The first stage of the process is the acquisition of the raw land for development. Raw land is typically bought by two types of investors: developers and speculators. Speculators are simply betting on price appreciation. The developer, on the other hand, generally is a specialist and has specific plans for the property. There are several sources of financing for land acquisition. One source is the traditional institutional lender. Developers sometimes prefer to warehouse property. This refers to holding large parcels of land in anticipation of development. Warehousing loans generally have a provision for the partial release of property as lots or units are sold.

Another source of financing for land acquisition is the seller of the property. This may take several forms such as seller financing or option contracts. The seller may become a lender by taking back a note from the buyer. There is usually a provision in this type loan that makes it subordinate to a subsequent construction loan.

After the land is acquired, the development stage involves making the site ready for construction. This may involve various steps such as zoning compliance, surveying, engineering, subdividing, and physical work such as road construction and utility installation. As with the other steps in the process, the land development lender is knowledgeable in judging the value of the collateral created by the improvements. Lending contracts for improvement will generally contain partial release clauses so that the developer can sell some developed lots before construction begins. The release clause may set requirements such as a minimum sales price to ensure sufficient funds to compensate for the release.

The construction loan is the final type of financing before the permanent or “takeout” loan. Construction loans are short-term for the length of the construction period. The interest rate will usually float with the prime rate. The loan-to-value ratio is generally in the 70 to 80 percent range. The construction lender will usually be a specialist in assessing the risk of the construction process. Things which the lender will typically do to control risk include (a) require an appraisal of the finished product, (b) review all construction plans, permits, etc., (c) disburse funds only for approved expenditures, (d) require “holdbacks” or reserves until all work has been completed, and (e) make sure there is a takeout commitment from the permanent lender. Figure One gives a typical loan submission checklist for a construction loan. Figure Two gives a typical real estate loan documentation checklist.

Funds are generally disbursed according to a draw schedule. The developer will want to borrow the funds on an as-needed basis to minimize interest costs. Since the project is not generating revenue during the construction phase, usually the interest will accrue and be paid when the permanent financing is secured.

#### *6.1.4 Permanent Financing of Commercial Real Estate*

Permanent financing refers to the long-term financing of existing or newly constructed properties. Financing commercial real estate refers to the use of debt relative to all-equity ownership. This type of financing can take the form of a fixed-rate mortgage, an equity participation loan, a sale-leaseback, and other options.

##### *The Long-Term Fixed-Rate Loan*

Long-term, fixed-rate mortgages are commonly used to finance commercial real estate. Most of these loans are originated by financial institutions such as commercial banks and life insurance companies. The loans are similar to fixed-rate mortgages on residential properties with several exceptions.

Commercial loans generally involve a more intricate underwriting process. For example, whereas the values of residential properties are usually determined by the comparable sales method, commercial property values are based more on their income earning capacity. Market factors which affect revenues will also affect the value of the property. Lenders realize that this increases their risk exposure and will therefore write these loans more cautiously. One result is lower loan-to-value ratios on income-producing properties relative to owner-occupied residential. Instead of the 80 to 90 percent (and sometimes higher) loan-to-value ratios observed on residential properties, income properties will be limited to the 60 to 80 percent range.

Any fixed-rate loan exposes the lender to interest rate risk. This is the risk of loss in value due to changes in market interest rates. Lenders try to mitigate losses from interest rate risk on commercial loans by writing prepayment penalties into the contracts. This is a penalty incurred by the borrower when a loan is prepaid. The prepayment penalty may be a percentage of the outstanding balance at the time of prepayment or it may be an amount related to the spread between the market rate and the contract rate. Thus the larger the spread between the market rate and the contract rate, the larger the prepayment penalty. A properly constructed prepayment penalty can eliminate the value of the refinancing option, regardless of the difference between the market rate and the contract rate.

For a typical residential property, the lender holds the property as collateral. Upon default, the lender has the right to initiate and proceed with foreclosure to have the property sold at a public sale. In the event of default on income-producing property, in addition to the foreclosure process, the mortgage contract may provide for an assignment of rents. This would allow the lender to step in and collect the rent payments directly from the tenants in the event of default.

Figure Three shows the typical structure of a retail mortgage. Basic loan parameters are illustrated along with borrower characteristics and other factors. Figure Four gives the same for mortgages on office properties and Figure Five shows the typical factors for multi-family property mortgages.

#### Equity Participation Loans

One alternative to the standard, fixed-rate commercial mortgage is the equity participation loan. Equity participation loans are sometimes referred to as “equity kickers” and refer to the participation in the income of the property by the lender. The lender generally offers a lower interest rate on the debt in return for a share of the income from the property and/or a share of the appreciation of the property. Generally, the lender will share in income over a specified minimum amount. In essence, the lender is taking both a debt position and equity position in the property and is advancing funds which are part debt and part equity.

An equity participation arrangement represents a tradeoff between the borrower and the lender. The lender foregoes some interest income for a right to share in residual income from operations and/or the sale of the property. From the borrower’s perspective, a properly

structured agreement would allow the borrower to tax-deduct both the interest and the residual payments.

The risk to the borrower is reduced by the participation agreement. In return for a portion of uncertain income, the borrower pays less interest (which may be fixed). At the same time, the borrower benefits by giving up part of the equity in the property without giving up ownership. The agreement will lower the debt service costs and reduce the break-even point. This increases the debt coverage ratio and reduces the probability of default. By nature of the equity participation agreement, the amount of equity financing (which is shared by the borrower and lender) is increased and the amount of debt financing is reduced. This results in less risk exposure for the borrower and increased risk exposure for the lender. Each participant would adjust the respective required return to value the anticipated cash flows.

There is an infinite combination of terms that can be used to create a participation loan. Along with alternative percentages, the agreement may specify a portion of either cash flow or net income. The loan may call for equity participation to begin after a given grace period. Regardless of the combination of terms that is agreed upon, the common point is that the lender has the right to receive a portion of the equity income by reducing the cost of the debt.

Equity participation loans were popular with thrifts in the mid-to-late 1980s. In those parts of the country that experienced declines in real estate values in the late 1980s and early 1990s, these ventures proved unsuccessful and thrift losses were greater than they would have been under more conservative financing methods.

#### *Sale-Leaseback Agreements*

An alternative to traditional ownership is the sale-leaseback. Under this scenario, the owner sells the property and simultaneously leases it back from the new owner. This agreement will generally contain an option to repurchase at the end of the lease term. A sale-leaseback is generally a consideration if the owner needs financing and the property is fully depreciated. The owner may consider simply taking a loan against the property or doing a sale-leaseback. In either case, the owner retains the use of the property. And, in either case, the owner acquires a tax deduction. The lease payments are deductible (in full) as is the loan interest.

One might argue that, if the cash flows are identical under the two alternatives, the lease alternative is preferable since it gives a repurchase option. If property values fall, the lessor simply does not exercise the option. Some sale-leaseback agreements, however, require the seller to guarantee a buy-back price to the buyer at the lease expiration. The agreement alternatively may not require the seller to repurchase the property but to indemnify the buyer in the event of declines in property value.

### Ground Lease Mortgages

Sometimes lenders will grant a loan against a ground lease. This is somewhat unusual since the borrower does not own the land but is simply leasing from the owner for development. Typically the lease terms call for ownership of the improvements to pass to the land owner at expiration of the lease. The lease may give the tenant a purchase option.

The legal treatment of ground leases can vary. Loans made to the owner secured by the lease are treated as real property in some states and personal property in others. Regardless, the lender has the right of foreclosure in case of default.

### Credit-Based Financing

There may be cases where the tenant has stronger credit than the landlord. In this case, credit-based financing may be a viable alternative. Credit-based financing uses the tenant's good credit rather than the real estate as collateral. Credit-based financing requires a direct financing agreement with the tenant and falls outside the bounds of traditional real estate financing.

There are two formats available for credit-based financing. In multi-site securitization, a pool of facilities are net leased to the tenant. A separate entity is created to construct the improvements and repay the debt which is collateralized by the properties and the rental revenues. Securitizing the debt this way may be desirable by the tenant rather than having the developer finance each site separately if the cost is less.

The second format is tenant improvements financing where tenant improvements are financed in a personal property lease. The tenant improvements but not the real estate are conveyed to a third-party financier.

Both tenants and landlords may have incentives to use credit-based financing. A tenant may use it to finance an expensive new facility or a group of facilities. A landlord may be able to use credit-based financing to provide substantial allowances which may, in turn, enhance property values and attract tenants.

## **7.0 PHASE VI: CONSTRUCTION AND LEASING PERIOD**

Stage Seven is critical in that, to undertake the construction process, major commitments of cash and labor are made. Negotiations are minimal since formal contracts are in place and the task now is producing the product. The developer becomes more of a manager than a negotiator. He is responsible for participants completing their tasks on time and within budget. The developer also continues to negotiate leasing agreements with tenants.

### **7.1 *Scheduling and Interaction***

Construction is the expensive stage of the process. Major resources are committed to completing the project. Previously, the developer may have kept out-of-pocket expenses to a minimum with the use of option contracts, etc. However, groundbreaking and beginning construction can produce substantial sunk costs. The developer's profitability as well as reputation are now on the line. Rarely can the developer simply delegate the management responsibility to the general contractor. Though the general contractor oversees construction, there must be coordination between the construction, marketing, financial, and public aspects of the process. A recurring theme is the importance of materials, labor, and equipment arriving at the site in the required quantities, at the right time, and in the proper sequence. The contractor oversees a complex fabrication and assembly process in which all components must be coordinated if the final product is to be on time, within budget, and to design specifications. The key is scheduling. Two considerations determine the sequence of events: (1) which events must occur before another one can proceed and (2) which events could proceed, if desirable.

Even though the general contractor manages day-to-day construction, the developer can keep an active hand in the process a couple of ways. The developer may have the architect who designed the project inspect the work at various stages to ensure that work is being done according to the specifications. Alternatively, the developer may employ an in-house construction manager to monitor progress. Historically, the former method was most common. As the construction process has become more complex, it is more common today to have a manager on site at all times to act as intermediary with the general contractor. In this way, important decisions can be made quickly.

The type of construction supervision may be dictated by the construction lender. The lender has a vested interest in having the construction process handled efficiently. Someone (maybe the architect or construction manager) must have the authority to do periodic sign-offs when draws are made on the construction loan. Construction lenders will also do inspections but these should not be relied upon to be technical reviews.

### **7.2 *Elements of the Construction Process***

Materials generally constitute the lion's share of the average contract. These include raw materials such as sand, lumber, and gravel. There may also be semifinished products such as preassembled trusses or prefabricated steel and there will be finished materials such as air conditioners, appliances, etc. Availability is the major concern after which the next concern is price.

Labor is the second major element of the construction process. This includes skilled labor such as carpenters, plumbers, masons, and welders and also unskilled labor for site cleanup, site preparation, etc. The first concern here is the availability of labor. Next, the contractor must be careful to determine when certain skills will be required and to assure that they will be available at the scheduled time.

Equipment is the third element of the process. With rising labor costs and shortages of certain types of skilled labor, contractors have relied more on equipment. The contractor must first determine what types of equipment will be required on the project. Then the contractor will weigh the benefits of owning versus renting the equipment.

### **7.3 *The Construction Manager***

The construction manager may be the developer himself. Alternatively, the manager may be architect, an in-house general contractor, or an engineer working as liaison with the general contractor. In any case, the construction manager should have some experience with the particular type of construction. Otherwise, there is more potential for problems and conflicts between the interacting parties as attempts are made to minimize costs and/or make changes while trying to hold true to the plans and specifications. In any case, an experienced construction manager would possess more clout and influence within the process.

### **7.4 *The Marketing Manager***

It is unlikely that the project will be completely preleased when construction begins. Thus, marketing will occur simultaneously with construction. Along with the uncertain identity of future tenants, their space and design needs are unknown. During construction, a full-pressure court on marketing must occur. Advertising should be stepped up and the sales force should be motivated to market the units. Marketing the units before or during the construction phase is important for a couple of reasons. First, the units can be designed or finished per tenant or buyer request. Second, as the units are marketed, it may become clearer what type of amenities etc. the market is demanding. In either case, a strong marketing approach in this phase should make for a more successful project.

### **7.5 *The Financial Officer***

Unless handled directly by the developer, a financial officer may be utilized to manage the relationship between the lender and investors. Funds are required to pay for the construction as it progresses. Also, changes in construction plans may entail greater costs (which are usually determined by the construction manager) that must be paid. The financial manager's job would be to determine the financing source for the additional costs. In other words, can the lender and/or the equity investors be persuaded to increase their financial commitment to cover the additional costs?

### **7.6 *The Property Manager***

It is important that the property manager be involved in the construction phase. At the conception of the project, the developer would have envisioned future management costs and

responsibilities. As construction progresses, changes as suggested by the marketing staff may result in changes in the manageability of the property. The property manager's job is to insure that proper consideration is paid to this aspect of the project.

### **7.7 *Getting the Construction Done***

Many developers undertake all or a portion of the construction process with their own staffs. The vast majority of construction, however, is performed by individuals and firms who are in the business of building for others for a fee. Thus a general contractor is used. The general contractor has the unenviable task of coordinating a number of subcontractors to accomplish given tasks. Subcontractors may include electricians, plumbers, dry wall installers, cabinet makers, etc. Unless the general contractor has his own crews for certain tasks, subcontractors must be used for all tasks. The general contractor must be careful to choose the subcontractors who have the skills to get the jobs done while operating within budget. Trying to economize by hiring someone with less skills than necessary can be risky.

One of the most difficult tasks for the general contractor is scheduling the different subcontractors. The general contractor must be forceful enough to keep the subcontractors on schedule but also flexible enough to make adjustments when necessary. Weather conditions and other factors can cause delays. If one task falls behind, it can cause scheduling problems for others since subcontractors may be working on different construction sites simultaneously. Or a subcontractor may already be committed to another job in the future.

The construction manager's main task is to protect the developer's interest. This requires working closely with the general contractor to insure that construction proceeds smoothly. The developer, in turn, must insure that construction is being coordinated with marketing. The developer must also make sure that construction is operating within budget as well as on schedule. In some cases, a developer with the necessary construction expertise may monitor individual subcontractor's progress.

### **7.8 *Drawing the Construction Loan***

Rarely do construction lenders make all construction loan funds available at the outset of a project. Typically, payments are made as the work progresses and only after the work has been done. The developer, of course, does not want to pay the general contractor until work is actually done. Disbursement is made according to a draw schedule. The developer must be careful to time lender inspections so that draws can be made when needed to pay for work. In other words, the developer would try to avoid having to pay for completed work from his own funds because someone failed to do a timely inspection.

There is generally a method to the draw schedule. Periodically (maybe weekly) the subcontractors will submit invoices of completed work. The general contractor will confirm that the submitted percentage of work has actually occurred by referring to the building plans and specifications. The general contractor then submits an invoice of the combined draw requests to the developer or construction manager. The developer may again verify that all submitted work has been done according to the plans and specifications.

The approved invoices are then sent to the financial manager who will combine these construction costs (“hard costs”) with other “soft costs.” Soft costs would include payments made directly by the developer such as property taxes, insurance, construction loan interest, administrative overhead, etc. This total amount is then submitted to the construction lender.

The construction lender generally confirms by physical inspection that the submitted work has been done and that the draw request conforms with the terms of the construction loan agreement. The construction lender then deposits funds into the developer’s account for the amount of the draw. It is common (and sometimes mandatory) that some of the construction amount, usually ten percent, be retained until the end of the job. This retainage is a major way to control risk in that it is paid only after the completed job meets all plan specifications. Sometimes lenders will control risk by dispersing funds through title companies. Subcontractors trade lien waivers for draw checks. This insures that the subcontractors have acknowledged payment when monies are dispersed. This helps prevent future mechanics’ liens filed by unpaid subcontractors.

#### ***7.10 Leasing or Marketing Space***

The developer would hope to lease any unoccupied space during the construction phase. Ideally, the project will be fully occupied or “leased up” at construction completion. Otherwise, the developer must plan for a possible operating deficit for a time after construction if the building is insufficiently leased to cover costs. Thus the developer may establish a leasing reserve to cover any costs in excess of the revenues.

Additionally, the construction loan may put restrictions on the disbursement of funds until a certain percentage of the building is leased. This puts added pressure on the developer to market the property. The general contractor or the subcontractors care very little whether marketing is on schedule and simply want to be paid for their work. The developer may be prepared to cover these costs himself or there may be an agreement with the lender to provide funds in exchange for a penalty. In any case, construction must continue or the costs continue to mount and the developer finds himself dealing with unhappy contractors.

#### ***7.11 Landscaping and Exterior Construction***

Landscaping may be used to enhance or draw attention from an unappealing building design or to attract tenants. In either case, landscaping is important. Landscaping can be used to set a project apart from its competitors or to make a project acceptable to its neighbors. It can also make a project appealing to those with environmental concerns. Landscaping is generally installed late in the construction period for two reasons: the developer doesn’t want to pay for additional maintenance and he doesn’t want the landscaping destroyed in the building process. An appropriate landscaping plan is critical since it is permanent and can be very expensive to change. Landscape maintenance is also critical since it is a very visible component and can be a major detraction from the appeal of the project.

## **8.0 PHASE VII: CONSTRUCTION COMPLETION AND INITIAL OCCUPANCY**

The construction completion and formal opening stage is a time when a number of things happen at once. In order to begin operations, there must be training of the operating staff, final marketing of the project, utilities connections, moving in of tenants, transition from construction financing to permanent financing, final inspections, and other things. The operations staff and the marketing people usually work together to handle pre-opening activity such as advertising and promotion. Hopefully, all interior finish work, etc. is completed in the construction phase so that tenants can move in with the least of inconvenience.

Along with all the hoopla of the grand opening, the developer will be shifting the financing of the project from the construction loan to permanent financing. Also, if there is a change in ownership, a shift in the controlling interest will occur. If the long-term investor is not the developer, then the developer's work is finished and the risk of the project is shifted to the new owner.

### ***8.1 Controlling for Risk During the Construction and Completion Phases***

The developer is under pressure to see that construction and marketing stay on schedule. Thus, he will seek ways to control the risks inherent in this process. There are some basic ways that the developer can reduce risk. These are:

1. Avoid or minimize risk by stopping the process in the early stages before much money is committed.
2. Have as comprehensive a feasibility study as possible to identify all possible risks.
3. Insulate as much as possible from potential problems and losses by assembling a competent and skilled development team.
4. Transfer as much risk as possible to other parties.
5. Be willing to assume risks but be aware of those risks.

Some techniques to accomplish the above are:

1. Performance Bonds and Retainage. These act to insure completion of the project in different ways. Performance bonds will guarantee that the project is completed as specified or will at least stand behind the general contractor's performance. Retainage helps insure that the general contractor will complete the work.
2. Architectural supervision and construction management. The developer should insure that all involved parties have the necessary licenses and experience to do their required tasks. The developer may require warranties from builders to insure structural integrity. The developer wants to be as protected as possible from subsequent lawsuits arising from inferior work of another party.
3. Liability, fire, and extended coverage insurance. The developer should make sure that insurance coverage is adequate and in place at the right time. He should review the insurance coverage periodically.
4. Preleasing and presales. The developer seeks to minimize initial vacancy and by developing the right mix of tenants. The developer may use devices such as net leases or expense escalations to control risk for long-term investors. The operating

agreement negotiated with tenants can also help to reduce future maintenance problems.

5. Good accounting controls. These can help keep administrative problems to a minimum.
6. Have an involved operating staff. This can help reduce the risk of poor service when the project opens. It may also help to reduce initial operating costs.

The development process is ever-changing, thus the developer must learn to be as flexible as possible. Design changes, changes in payment schedules, and changes in the construction process itself must be anticipated. In addition, changes in market conditions can cause changes in marketing strategies. There must be constant interaction between the construction, marketing, financial, and operating personnel. The developer's role is to make sure that these parties are compatible in working toward the common goal of completing a successful project. The developer must be an effective promoter and manager. Project completion and formal opening ends the phase of active construction and begins the phase of operations and property management.

## **9.0 PHASE VIII: PROPERTY MANAGEMENT AND DISPOSITION**

### **9.1 *Property Management***

The management of real estate assets is performed by portfolio managers, asset managers, and property managers. The roles of portfolio manager is to assess how particular property investments affect the portfolio's risk and return performance. Their objective is to identify a set of properties that will minimize the investor's downside risk for a given required return. Asset managers manage a group of projects, handling the logistics of their purchase, operations, and disposition.

The asset managers' tasks involve working with real estate brokers and owners to find potential property investments that satisfy the scale and location objectives established by the portfolio manager. The asset manager, advises the investor/developer on the purchase price, physical condition, and terms of the purchase for each potential investment, and makes recommendations for development and purchase. At the end of the holding period, the asset manager will advise the investor about marketing the property and the terms of the sale.

Property managers carry responsibility for all aspects of the physical space in accordance with the asset manager's plan. The property manager's responsibilities include marketing and leasing, maintenance and repairs, tenant relations, insurance, accounting, human resource management, and providing timely information to the asset manager about events affecting the property.

The objectives of the property manager are to generate income and control expenses. In doing so, property values are enhanced. Although managers tend to first concentrate on easily corrected problems, such as out-of-control expenses, the potential returns from focusing on income generation often exceed those from controlling expenses.

## **10.0 ADDENDA**

### **Exhibit 10-1**

#### **Construction Loan Submission Checklist**

Location Map  
Site Plan  
Property Analysis Sheet  
Gap Analysis  
Operating Deficit Calculation  
Base Review/Relationship Review of Borrower/Guarantors  
Discounted Cash Flow Analysis  
Total Corporate Exposure Summary  
ROA Calculation  
Credit Analysis of Anchor Tenants  
Permanent Loan Commitment  
Permanent Lender Financial Statements  
Permanent Lender Credit Department Analysis  
Appraisal  
Standard Form of Lease  
Anchor Lease(s)  
Other Leases  
Operating Statements  
Contractor Resume  
Architect Resume  
Contractor Financial Statement  
Credit Reports

**Real Estate Loan Documentation Checklist**

- Commitment Letter
- Loan Agreement/Mortgage and Security Agreement
- Permanent Loan Commitment
- Attorney's Opinion Letter
- Appraisal
- Appraisal Review
- Title Insurance
- Title Endorsements (as applicable):
  - Form 9
  - Contiguity
  - Survey
  - Variable Rate
  - PUD
- Property Insurance:
  - Business Interruption
  - Permanent Hazard
  - Builder's Risk
  - Flood Insurance
  - Owner's Liability
  - Contractor's Liability
  - Workmen's Compensation
- Survey and Surveyor's Certification:
  - Boundary
  - Foundation
  - Plat
- Authority Documents:
  - Partnership Agreement
  - Corporate or Partnership Resolution
  - Certificate of Good Standing
  - Articles of Incorporation
  - By-Laws
  - Fictitious Name Affidavit
  - Articles of Limited Liability Co.

**Real Estate Loan Documentation Checklist**

Engineering Reports:

- Concrete Tests
- Soil Compaction Tests
- Construction/Property Inspections
- ESA/ESI
- Plan and Cost Review
- Plans and Specs (as-built for existing buildings; proposed for new construction)
- Property Management Agreement/Subordination of Agreement and Fees
- Franchise Agreement
- Sales Contracts/ Assignment of Sales Contracts
- Escrow Deposits/ Assignment of Escrow Deposits
- Pre-Sale Requirements
- Condominium Documents
- Certificate of Occupancy
- Unconditional Payment/ Performance Bonds
- Construction Contract
- Architect's/ Engineer's Contracts and Assignment of Those Contracts
- Building Permit
- Utility Letters (Water, Sewer, Electricity, Phone)
- Zoning Evidence
- Development Approvals (Water Management, etc.)
- Lease Digest (For All Anchor Tenants and Standard Local Lease Form)
- Certified Copies of All Leases
- Tenant Estoppel Certificates
- Subordination Agreement
- ADA Compliance
- Financial Statement Requirements
- Concurrency/ Comprehensive Plan
- Subordinated Debt - Subordination Agreement
- Indicate Equity Contribution Breakdown (Upfront, Ongoing, Deferred)
- Other Documents Required as Necessary

## Retail Mortgage Program

### Basic Loan Parameters

*Eligible Property:* Anchored and unanchored strip centers, free standing centers, and outlet centers

*Loan Size:* One million dollars and above

*Security:* First mortgage secured by fee simple ownership

*Loan Term:* 5, 7, 10, and 15 year maturity loans and 15 and 20 year fully amortizing loans

*Amortization:* Maximum of 30 years

*Loan-to-Value Ratio:* Maximum 75% of MAI-approved appraisal for anchored or unanchored strip, 70% for free standing centers, and 65% for outlet centers

*Interest Rate:* Fixed rate at a spread over U.S. treasury issue

*Debt Service Coverage:* Minimum of 1.20:1

*Prepayment:* Yield maintenance

*Recourse:* Nonrecourse, except with respect to (1) liability relating to hazardous waste and toxic substances, (2) fraud, waste, misrepresentation, or misappropriation, (3) unauthorized transfer of title, and (4) all costs, expenses, and losses resulting from borrower bankruptcy

*Escrows:* Monthly escrow for property taxes, insurance, and replacement reserves

*Reserves at Closing:* Escrow of 125% for deferred maintenance and/or environmental remediation

*Specific Reserves:* Specific reserves may be required for major capital improvements

*Subordinate Financing:* Prohibited

*Assumption:* For a fee of 1%, Borrower has one-time right to transfer the loan and title subject to Lender's written approval

### Borrower Requirements

*Borrower:* Single purpose, single asset, bankruptcy remote entities

*Financial Condition:* Borrower's financial condition and liquidity should be sufficient to cover potential capital expenditures and/or operating deficits

*Management:* Borrower's management organization should have at least five years experience owning and managing properties similar to the subject

### Commitment Fees/Closing Costs

*Commitment Fee:* 1% of the loan amount

*Closing Costs:* Borrower pays normal and customary closing costs, including third party reports, title insurance, survey, escrow and recording fees, legal fees,

processing fees, and site inspection fee

**Exhibit 10-3 (cont'd)**

**Third Party Required Reports**

FIRREA conforming MAI appraisal

Architectural/Engineering report

Phase I environmental audit and asbestos survey

**Legal Documentation**

Standard loan documents with no substantive negotiation

Source: Renaissance Financial, Inc.



## Office Mortgage Program

### Basic Loan Parameters

*Eligible Property:* Class A, B, and C suburban and downtown office buildings  
*Loan Size:* One million dollars and above  
*Security:* First mortgage secured by fee simple ownership  
*Loan Term:* 5, 7, 10, and 15 year maturity loans and 15 and 20 year fully amortizing loans  
*Amortization:* Maximum of 25 years  
*Loan-to-Value Ratio:* Maximum 75% of MAI-approved appraisal dependent on location, age physical condition, current lease terms, and other factors  
*Interest Rate:* Fixed rate at a spread over U.S. treasury issue  
*Debt Service Coverage:* Minimum of 1.25:1  
*Prepayment:* Yield maintenance  
*Recourse:* Nonrecourse, except with respect to (1) liability relating to hazardous waste and toxic substances, (2) fraud, waste, misrepresentation, or misappropriation, (3) unauthorized transfer of title, and (4) all costs, expenses, and losses resulting from borrower bankruptcy  
*Escrows:* Monthly escrow for property taxes, insurance, and replacement reserves  
*Reserves at Closing:* Escrow of 125% for deferred maintenance and/or environmental remediation  
*Specific Reserves:* Specific reserves may be required for major capital improvements  
*Subordinate Financing:* Prohibited  
*Assumption:* For a fee of 1%, Borrower has one-time right to transfer the loan and title subject to Lender's written approval

### Borrower Requirements

*Borrower:* Single purpose, single asset, bankruptcy remote entities  
*Financial Condition:* Borrower's financial condition and liquidity should be sufficient to cover potential capital expenditures and/or operating deficits  
*Management:* Borrower's management organization should have at least five years experience owning and managing properties similar to the subject

### Commitment Fees/Closing Costs

*Commitment Fee:* 1% of the loan amount  
*Closing Costs:* Borrower pays normal and customary closing costs, including third party reports, title insurance, survey, escrow and recording fees, legal fees, processing fees, and site inspection fee

**Exhibit 10-4 (cont'd)**

**Third Party Required Reports**

FIRREA conforming MAI appraisal  
Architectural/Engineering report  
Phase I environmental audit and asbestos survey

**Legal Documentation**

Standard loan documents with no substantive negotiation

Source: Renaissance Financial, Inc.



## Multi-Family Mortgage Program

### Basic Loan Parameters

*Eligible Property:* Garden and low-to-mid rise multi-family properties

*Loan Size:* One million dollars and above

*Security:* First mortgage secured by fee simple ownership

*Loan Term:* 5, 7, 10, and 15 year maturity loans and 15 and 20 year fully amortizing loans

*Amortization:* Maximum of 30 years

*Loan-to-Value Ratio:* Maximum 80% of MAI-approved appraisal dependent on location, age, occupancy, physical condition, and other factors

*Interest Rate:* Fixed rate at a spread over U.S. treasury issue

*Debt Service Coverage:* Minimum of 1.20:1

*Prepayment:* Yield maintenance

*Recourse:* Nonrecourse, except with respect to (1) liability relating to hazardous waste and toxic substances, (2) fraud, waste, misrepresentation, or misappropriation, (3) unauthorized transfer of title, and (4) all costs, expenses, and losses resulting from borrower bankruptcy

*Escrows:* Monthly escrow for property taxes, insurance, and replacement reserves

*Reserves at Closing:* Escrow of 125% for deferred maintenance and/or environmental remediation

*Specific Reserves:* Specific reserves may be required for major capital improvements

*Subordinate Financing:* Prohibited

*Assumption:* For a fee of 1%, Borrower has one-time right to transfer the loan and title subject to Lender's written approval

### Borrower Requirements

*Borrower:* Single purpose, single asset, bankruptcy remote entities

*Financial Condition:* Borrower's financial condition and liquidity should be sufficient to cover potential capital expenditures and/or operating deficits

*Management:* Borrower's management organization should have at least five years experience owning and managing properties similar to the subject

### Commitment Fees/Closing Costs

*Commitment Fee:* 1% of the loan amount

*Closing Costs:* Borrower pays normal and customary closing costs, including third party reports, title insurance, survey, escrow and recording fees, legal fees, processing fees, and site inspection fee

**Exhibit 10-5 (cont'd)**

**Third Party Required Reports**

FIRREA conforming MAI appraisal  
Architectural/Engineering report  
Phase I environmental audit and asbestos survey

**Legal Documentation**

Standard loan documents with no substantive negotiation

Source: Renaissance Financial, Inc.

# **Florida Growth Management**

**An overview of development regulation and environmental management  
procedures**

## Background

The state of Florida has an unenviable dilemma: preserving some of the most fragile ecosystems in the United States while simultaneously accommodating a burgeoning population. From the Everglades in central and south Florida to the vast freshwater aquifers of north Florida, the state is covered with wetlands, forests, and seashores that are all vulnerable to over-development. Ironically, these same environmental resources are what attract many of Florida's new residents. Recognizing the overwhelming demand for new development, as well as the human tendency to allow short-sighted economic considerations to outweigh long-term environmental impacts, the state government has taken an extremely proactive approach to planning for a growing population and protecting the environment. The state's actions include:

- Growth management legislation
- Creation of state planning and environmental protection agencies
- Creation of regional planning and environmental management agencies
- Mandatory local comprehensive planning and development regulation

Anyone wishing to undertake large-scale development in the state of Florida should be aware of the growth management and environmental protection framework established by state government. The list above describes, in general fashion, the way the system is supposed to work. Any development has to comply with local planning and development regulation. Regional planning agencies may watch the local agencies to ensure that their plans and regulations are enforced, reporting any discrepancies to the state planning and environmental protection agencies. The state agencies enforce the laws and regulations for growth management, in accordance with the state's growth management legislation. Along the way, environmental protection agencies at several levels monitor the impact of development on water quality, endangered species, and stormwater flow.

This description is somewhat oversimplified, rather like explaining that airplanes fly because they have wings, but it outlines the general process from a developer's point of view. In actuality, there is a great deal of cross-connection between the different agencies, and the hierarchy of functions is not nearly this rigid. For instance, an individual citizen can appeal directly to the State agencies (and they often do) and completely bypass the regional planning agencies. The regional planning agencies, in turn, spend a great deal of their time ensuring that local plans are consistent with regional plans – being a growth management watchdog is only one part of the regional planning function. The environmental managers operate from different legislation and may have different priorities from development regulators. From the developer's perspective, however, the scenario above describes the general way that the growth management system operates.

Like many complex issues, there are myriad different ways that a development scenario can play out. Every development is different, and in a way, each development creates and follows its own development process. So rather than attempt to explain a process that does not really exist, the following sections describe the elements of Florida's growth management system and their relationships to each other. Using this information, one can determine how a development process might unfold in a given situation. The description is roughly analogous to the Milton Bradley game "Monopoly" – there are players, rules, and situation cards, but there is no way to know the outcome before the game is over. However, in real life one can more easily "cheat". By understanding the relationships between the different elements of the growth management process, one can learn in what order the situation cards are stacked. By knowing what's coming next, one can create a more viable strategy for winning the Florida growth management "game." Because the development regulation and environmental regulation processes operate somewhat independently of one another, each process is described below as its own game.

## The Development Regulation Game

This section describes the rules of the Florida Development Regulation Game (the legislation and departmental procedures); the players (the agencies, persons, and levels of government recognized in the legislation); and the common situations that may arise when the growth management process is underway.

### The Rules: Florida's Growth Management Legislation and Procedures

Table 1, below, contains the titles of relevant growth management legislation, with a brief description of the importance of each item. The primary document from which all other growth management procedures spring is FS CH 163, Part II, which prescribes by law the county and municipal planning and land development regulations. This document describes the procedures for city and county planning and designates the Department of Community Affairs as the state's land planning regulatory agency. Chapter 163 sets up the following procedure for comprehensive planning in the state of Florida:

1. Cities and counties must prepare comprehensive plans and submit these plans to the Department of Community Affairs for review. Chapter 163 describes what elements must be included in the local comprehensive plan (Table 2), as well as the process for making amendments to the comprehensive plan.
2. The Department of Community Affairs reviews the local comprehensive plan to ensure that it is in accordance with Chapter 163. The Department uses its own internal Rule, 9J-5 (described in Table 1) to determine whether local plans and amendments are actually in compliance. If the comprehensive plan is not in compliance, the Department must submit the plan for review by a hearing officer with the Division of Administrative Hearings, in which the Department must prove its finding of non-compliance. If the hearing officer also finds that the plan is not in compliance, the plan will then be submitted to the Administrative Commission, which includes the Governor of the state of Florida. Chapter 163 describes the actions that the Administrative Commission may take to force the local community to bring the comprehensive plan into compliance, including the withholding of certain types of state funding.
3. Once the local comprehensive plan is found to be in compliance by the Department of Community Affairs, Chapter 163 requires that local governments create land development regulations to ensure that the comprehensive plan is actually carried out. The Chapter requires the Department of Community Affairs to adopt rules for the review of these land development regulations (this is Rule 9J-24: Rules of the DCA Division of Resource Planning and Management Land Development, described further in Table 1). Rule 9J-24 also describes the actions that the Department may take to force local governments to bring their development regulations into compliance.

In addition to requiring local government to create and implement comprehensive plans, Chapter 163 also provides a mechanism by which developers can assert their rights to develop under the comprehensive plan. Ss. 163.3220-3243 describe the Development Agreement, a contract between the local government planning agency and developer, describing what will be built, when and where the development will take place, and what each party will do to facilitate the development. For instance, the developer might agree to improve problem intersections related to the development site, and local government might agree to extend municipal water and sewer services to the development site. All of these negotiations are written down in the Development Agreement, which then becomes a binding document on both parties.

Chapter 163 provides the basic outline for growth management. Under the mandate of this legislation, other state agencies such as the Department of Community Affairs have developed their own rules and procedures for implementing Chapter 163, including 9J-5 and 9J-24, mentioned above and described in Table 1.

Legislation	Description
<b>Chapter 163</b> Intergovernmental Programs Part II County and Municipal Planning and Land Development Regulation	Outlines entire process of state planning, describes role of Department of Community Affairs, describes terms used in planning discussions.
<b>9J-5</b> Minimum criteria for review of local government comprehensive plans and plan amendments and determinations of compliance	Rule used by the Department of Community Affairs to evaluate local comprehensive plans.
<b>9J-24</b> Rules of the Department of Community Affairs Division of Resource Planning and Management Land Development	Says why and how DCA can review development regulations and outlines procedures for ensuring regulations meet state standards.
<b>CH 28-24</b> Developments Presumed to be of Regional Impact.	Describes all about what constitutes a DRI, including size and density thresholds for different types of developments.

**Table 1: Florida Growth Management Legislation**

In summary, the rules for the growth management game:

1. All local development must comply with local development regulations
2. The development regulations are determined by the local comprehensive plan, which in turn is reviewed and approved by the Department of Community Affairs.
3. Because each county and municipality is different, local governments are encouraged to create comprehensive plans and development regulations suited to their own needs, provided the state's rules for growth management are observed.
4. Consequently, the development rules in any given area may be quite complex or fairly simple, depending on several factors such as:
  - The desire of the community to encourage or discourage growth
  - The growth rate and size of the community
  - The type of development being considered

The last factor above is very important. Certain types of large developments can trigger an enhanced level of growth management regulation, known as "Developments of Regional Impact", or DRI's, as defined in CH 28-24 and FS 380. The development of regional impact process recognizes that some types of development can have tremendous impacts on growth patterns, traffic, and the environment and must be dealt with at the regional or even statewide level. The DRI legislation and procedures set the thresholds at which developments are considered worthy of deeper scrutiny. CH 28-24, summarized in Table 1, is used by the Department of Community Affairs to determine whether a development qualifies as a DRI.

Comprehensive Plan Elements Required by Chapter 163
<ol style="list-style-type: none"> <li>1. Capital Improvements</li> <li>2. Future Land Use</li> <li>3. Traffic Circulation</li> <li>4. Sanitary Sewer, solid waste, drainage, potable water, natural groundwater aquifer recharge element</li> <li>5. Conservation element for conservation, use, and protection of natural resources in the area</li> <li>6. Recreation and open space element</li> <li>7. Housing element</li> <li>8. Coastal management element (if required by s. 380.24)</li> <li>9. Intergovernmental Coordination Element</li> </ol>

**Table 2: Required Elements of the Comprehensive Plan**

These rules and procedures summarize the primary elements of growth management regulation in the state of Florida. In addition to growth management regulation, however, any developer must also consider environmental impacts from development. The state Department of Environmental Protection oversees this aspect of development regulation, as described in the section of this paper entitled *The Environmental Management Game*.

## **The Players**

Growth management legislation sets the stage for development in Florida, or to continue the game analogy, provides the gameboard and the rules. One must also consider the players, who are described below.

**The Developer:** Chapter 163.3164 defines developer as “any person, including a governmental agency, undertaking any development as defined in this act.” The developer can be an individual who wishes to improve some personal property; a development firm wanting to build an amusement park or residential development; or even a government agency wanting to build a new office complex. Florida’s growth management legislation really does not exclude anyone from following its mandates. For the most part, the developer is the player who initiates the growth management process. By attempting to develop a parcel of land, the developer sets a growth management process in motion and begins the growth management game.

**The local government:** This can be a city or county government, or both. The local government is responsible for preparing a comprehensive plan, creating development regulations to implement the plan, and enforcing the development regulations. The local government is usually the first other player encountered by the developer. Note that the local government is often several different entities, each handling a different aspect of development. Some commonly encountered variants of local government are:

- City and/or County Growth Management: Responsible for implementing the development regulations and environmental regulations
- City and/or County Planning Department: Responsible for creating and amending the Comprehensive Plan and development regulations.
- City/County Boards of Commissioners or Councils: Elected officials who exercise legislative authority over the local area.
- Metropolitan Planning Organization: Responsible for local transportation planning and road construction. Has final authority to locally approve the transportation plan, which can affect access to land.

In addition to working with developers, the local government must also interact with the Department of Community Affairs and the Regional Planning Agency.

**Department of Community Affairs:** The “state land planning agency”, as defined in Chapter 163. DCA is responsible for reviewing local comprehensive plans and development regulations to ensure their compliance with state law. DCA is also responsible for operating the Development of Regional Impact program. Unless a development is large enough to be a DRI or requires a comprehensive plan amendment, the developer should have little need to interact with the DCA.

**Regional Planning Agency:** Recognizing that many aspects of comprehensive planning have affects beyond county boundaries, DCA has established regional planning agencies to coordinate the planning efforts of counties within the same geographical region. The regional planning agencies have no real teeth of their own – they do not approve local comprehensive plans or enforce development regulations – but they are closely tied to the DCA and can serve as watchdogs for development problems. RPA’s are generally more aware of the local development scene than the DCA, and are more likely to attend local planning meetings and public hearings. The RPA’s are also responsible for preparing local comprehensive plans for communities that cannot or will not

prepare their own plans. The RPA's prepare a regional strategic policy plan, which is then used by DCA when reviewing local comprehensive plans. Essentially, the RPA's serve as a resource, providing a broad perspective on development issues and keeping an eye on local development regulation enforcement.

**The Public:** The public pays for the growth management game and often participates as well. City, County, Regional, and State planning are all supported by public funds. If these agencies perform their roles poorly, the public pays through environmental degradation, traffic congestion, and a diminished quality of life. Chapter 163 requires that the public provide input on all comprehensive plans and comprehensive plan amendments. Frequently, the public will attend public hearings on development issues to offer its opinion on how the issues should be resolved. Public comment might range from "I'd love to have a new Texaco next door" to "These trees are really pretty, and you shouldn't cut them down to build a Wal Mart." Chapter 163 provides numerous opportunities for the public to submit complaints, petitions, or requests for review of growth management activities. Consequently, the public can, if well-informed and somewhat organized, often delay a development for some time.

**The Administrative Hearings Division:** Whenever the Department of Community Affairs finds that a local comprehensive plan is out of compliance, Chapter 163 requires the department to schedule a hearing with the Department of Management Services Administrative Hearings Division. Once scheduled, the DCA must then offer the local government a chance to resolve the dispute over the compliance of the comprehensive plan. If the local government and the DCA can reach an agreement, then the hearing is canceled. Otherwise, the administrative law judge holding the hearing will determine whether the DCA has presented sufficient evidence to find the comprehensive plan in non-compliance. Following the hearing, the judge will submit a recommendation to the Administration Commission regarding final action on the finding of non-compliance.

**The Administrative Commission:** As defined in Chapter 163, the Administrative Commission means the Governor and the Cabinet. This commission has final authority to implement sanctions against local governments who do not bring their plans into compliance. Chapter 163.3184 (11) describes the sanctions available to the Administrative Commission.

### **The Situation Cards—how the relationships work.**

Having described the rules and major players in the Florida Growth Management Game, this section examines two ways that a development scenario might occur.

### **The Model – an ideal, painless development scenario**

You are a developer. You have decided to make money by developing a new office complex in a medium-sized Florida city. After doing your market research, you decide that a vacant lot in a rapidly growing part of town is the ideal location for your development. You consult the city planning office and discover that the parcel you have in mind is, in fact, zoned for office development at a density very close to your projected market value. You hire a consultant to design and build your office park. The consultant checks with the city Growth Management Department to ensure that the proper arrangements are made for stormwater runoff, noise abatement, and other impact mitigation measures. The consultant also ensures that the estimated traffic impacts of your office park are within allowable limits. Because of Florida's transportation concurrency requirements, you have to pay a fee to the city for the reconstruction of a nearby intersection that will be overloaded by your office park's traffic. You make all the proper arrangements, build the office park, advertise it, and fill it with tenants who all deliver their rent on time. Then you sell the entire park to a

property management company, put your profits in the bank, and retire to a small, exclusive Caribbean resort island.

## The Reality – what can go wrong, will go wrong

You are a developer. You have decided to make money by developing a new office complex in a medium-sized Florida city. After doing your market research, you decide that a vacant lot in a rapidly growing part of town is the ideal location for your development. You consult with the city planning office and discover that the parcel you have selected is, in fact, zoned for a much lower office density than your market projections indicated would be profitable. You might ask the city planner if the zoning can be changed to a slightly higher density to accommodate your office complex. Ordinarily, explains the planner, that might be possible, but not in this case. You see, the comprehensive plan has designated this area as a “neighborhood service node”, and high-density office zoning is not allowed in such an area. To change the zoning would violate the comprehensive plan. Well yes, you explain, but this is a rapidly growing part of town. Perhaps the plan should be amended to account for the greater-than-expected growth pressure. The planning department could deny your request for a plan amendment, but for argument’s sake assume they agree that a plan amendment is in order.

The city planning department issues notice of the required public hearing on the plan amendment. The Regional Planning Council reviews the proposed amendment and finds it out of compliance with their regional strategic policy plan, which generally encourages neighborhood-scale development. Consequently, a regional planner attends the public hearing to announce this fact. The RPC also notifies the Department of Community Affairs of the proposed plan amendment. At the public hearing, a large group of citizens representing the neighborhoods surrounding your vacant parcel speak out against the amendment, explaining that their children play on the vacant lot. In addition, a local ornithologist reveals that your vacant parcel is actually home to a mated pair of rare blue-headed moss-muncher sparrows, which are candidates for the endangered species list. At this point, the local planning board, who reviews comprehensive plan amendments, could turn down the amendment, but assume they do not. They recommend to the city commission that the amendment be approved. At this point, the neighborhood groups, the environmentalists, or any other interest group could file suit in court to stop the plan amendment. Regardless of the outcome, the amendment would be held up in court for some time. The city commission could also go against the recommendation of the planning board and deny the amendment, but again, assume they approve the amendment. It looks like you’re going to get your plan amendment!

But wait! The Department of Community Affairs, alerted by the Regional Planning Commission and the other opposition groups, requests a review of the plan amendment. After 90 days, they return a report stating the amendment is not in compliance with Rule 9J-5. They have found that the plan amendment violates state requirements for adequate public facilities. In addition, the Department of Environmental Protection has found that a pond on the site now qualifies as a wetland. Your plan amendment is sent before a hearing officer at the Division of Administrative Hearings. The hearing officer concurs with DCA’s findings, so your amendment is sent to the Governor with the recommendation that it be denied. At this point, your amendment would probably be dead, but let’s assume that you once rescued the Governor’s pet raccoon from a pack of ravenous pit bull dogs, so he owes you a favor. Using his influence, he convinces the Cabinet to overturn DCA’s finding and allow your plan amendment. Your city’s comprehensive plan is now amended, after at least one year of effort.

Now that you have the plan amendment, you can request the rezoning. At this point, all of the groups that opposed the plan amendment can come back out and oppose the rezoning. This time, they are even more determined. They hold a bake sale to raise money and take you and the city to court over the rezoning. Your financing institution, highly discouraged by the delays in building your office complex, withdraws its funding support. All of your personal income that was invested in the project is now wasted, and you are penniless and deep in debt. Discouraged and disgusted, you turn to alcohol to ease your pain and

eventually wind up homeless on the streets of some other medium-sized Florida city, a loser in the Florida Growth Management Game.

### **Stacking the deck in your favor**

These descriptions are an attempt to bracket the possible ways that a development scenario might play out. However, every development situation is unique and will face different challenges and have different advantages. By knowing the possible development –regulation problems that could be encountered, a developer can take appropriate steps to mitigate these problems before the development game begins. The list below contains several ways to do this.

- Read the local comprehensive plan. Try to get a general idea of the way the plan intends for the area to grow. Look for concentrations of activity, as well as places where development is being discouraged (such as conservation areas and wetlands.)
- Review the zoning map, if one exists. It should reflect the comprehensive plan.
- Avoid having to request a plan amendment or zoning change, if possible. Plan amendments attract the attention of the DCA as well as local groups who may oppose your development for any number of reasons.
- Sometimes, plan amendments may be unavoidable. Your development may be something that was simply never considered when the comprehensive plan was created, for instance. Or, your development may reflect some new change that has occurred since the creation of the Comprehensive Plan, such as the unexpected closing of a road economic decline of a neighborhood. If a plan amendment is necessary, and if you have sufficient time to wait, you may be able to effect a change of the plan during the next Evaluation and Appraisal Report. DCA requires all local governments to prepare such reports every 5 years. This would be an appropriate time to amend the Comprehensive Plan to fit your development more closely.
- Determine Your DRI Status: Are you a Development of Regional Impact? Check the DRI thresholds for your type of development. If possible, build under these thresholds. If you cannot avoid becoming a DRI, you should start as early as possible (and as high up the process as you can) to build support for your project.

The Development Regulation Game is one major aspect of growth management in Florida. The other aspect is the Environmental Management Game, described in the next section.

## **The Environmental Management Game**

This section addresses the procedures of the different levels of government involved in the regulation of the environment with respect to new development. Furthermore, this section describes two possible development situations that might arise for a prospective developer.

### **Local Government Procedures**

When a developer finds a parcel of land that is desirable, there may be a number of environmental permits required. The most important thing to remember is that unlike the growth management rules, there is no CH 163 from whence all regulations spring. The Federal government has passed laws such as the Clean Air and Water Acts however, and those are the basis of the state and local governments' environmental regulation.

Each county has its own set of regulations with varying degrees of complexity. A developer needs to know the rules of the county in question before doing anything else.

The first step in addressing local government procedures is to have an environmental specialist come to your property and inventory the resources present. For developers, hiring a consultant is absolutely necessary. The consultant will delineate environmentally sensitive areas through flagging. Next, a surveyor can tell you approximately how much area of environmentally sensitive land there is on the development site. Lastly, the county or Water Management District (WMD) representative will come out and review the delineation and/or area. In Florida, one of the main concerns is the presence of wetlands. If a development site has less than 0.5 acres of wetland (on average, may be more or less) it can be altered without mitigation.

Generally, the county's growth and environmental management office is responsible for the local part of the permitting process. Again, environmental concerns and regulations vary tremendously from county to county, based on things such as water quality, endangered species, wetlands, and various other environmental factors. The most common permits required are the Environmental Resource Permit (applied with the WMD) and/or the Water Use Permit. Normally, a Water Use Permit is required only for large scale agricultural, industrial, or residential use.

If a county doesn't have an environmental permitting procedure, that by no means indicates that you're done. EVERY local government requires authorization through the state and/or WMD process.

Counties that don't require separate permits aren't necessarily blasé about the environment. Land development regulations, which are formed through the comprehensive plan, have an environmental management section. That section details the rules for the county that must be followed but don't need a separate permit. More often than not, counties that don't require separate permits are the sparsely populated areas and would welcome any growth in the area; thus required permits are less restrictive.

In addition, there is always something that is at least indirectly related to the environment in the local permitting process and is usually stuck together with the overall site plan package.

## **State/Water Management District Procedures**

The state Department of Environmental Protection (DEP) is mostly responsible for delegating authority to the regional and local jurisdictions. They also issue permits for developments that concern bay bottoms and larger environmental systems.

The agency that most developers need to be concerned with is their regional Water Management District. They are similar to mini DEP's and handle the bulk of the permits. WMD's are most concerned with water runoff volume, water quality, and impact on wetland habitats.

Most new developments file for an Environmental Resource Permit (ERP) through the local WMD. The application must have five copies sent to the WMD who then submit it to the DEP and to the Army Corps of Engineers. The DEP is most concerned with dredge and fill (wetlands), surface flow across development, and possible impacts on state lands and/or water bodies. The Corps starts its own process only if there are wetlands present (greater than 0.5 acres). If there are no wetlands, then nothing is sent to the Corps.

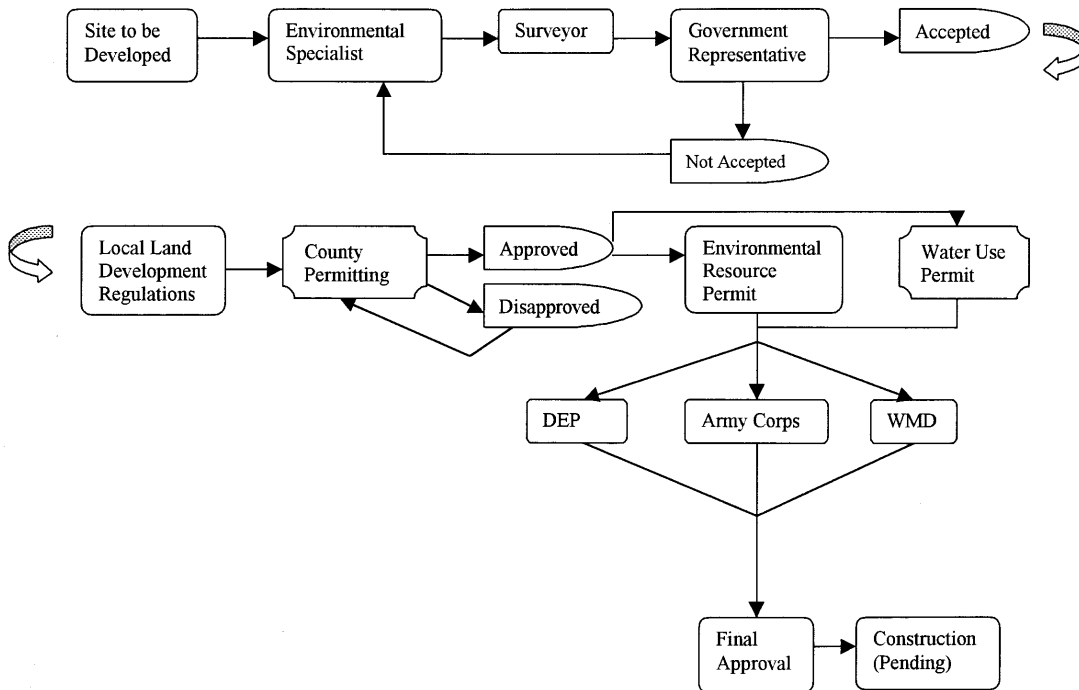
The Environmental Resource Permit is the most common permit filed with the local WMD. The permit requires that if there is more than 0.5 acres of wetland, the developer detail the impact to the system, propose mitigation for the system, and propose maintenance for the system. The study is very detailed and is the most difficult to pass due to all the extenuating circumstances that can arise. A visual aid for the entire process is provided in Figure 1.

In addition, certain water supply systems require a permit from the State Dept. of Health. Usually the state or WMD district handles this, but depending on the development, Health may be involved. The Fish and

Wildlife Department may also become involved if the development impacts a threatened species and/or habitat.

As with most things, there are exemptions depending on who you are (Disney) and how much money you have...

AND just because you passed your environmental test that doesn't give you a building permit, you must still meet the development regulation requirements



**Figure 1 : Environmental Management Process Flowchart**

### Development Scenarios

The following two scenarios are an attempt to combine the information above into a narrative description of the environmental regulation process. The two admittedly simplified scenarios bracket a wide range of possible outcomes, from painless prosperity to devastating disappointment.

#### Happy Days

You are a developer. You have decided to make your money by developing a new mixed-use office complex in an average Florida city. After doing your market research you decide that a vacant lot in a growing part of town will best suit you. You contact finest consulting firm in town and have their environmental specialist come to your property and walk the grounds. The specialist finds that of the 40 acres your property has 5 acres that is considered wetland in the northwest corner of the lot.

You then file for an ERP with the local WMD. In the application you show how the proposed development will impact the system. You plan on building an L-shaped buffer in the form of a retention pond (which is required anyway) around the wetlands. During the review time the county comes out to confirm the report from the consultant and everything checks out. The application comes back approved. You then have a site plan review with the county in which you detail the proposed runoff and water supply issues. The county tells you they were in the process of extending water lines to your area anyway, so you don't have to wait. The Corps rubber stamps your plan, you build the complex, advertise, and fill it with tenants who always pay on time. You then sell the whole thing to a property management company, put your profits into a condo in Aspen and retire amongst the rich and semi-famous.

## Reality Bites

You are a developer. You have decided to make money by developing a new mixed-use office complex in a medium-sized Florida city. After doing your market research, you decide that a vacant lot in a rapidly growing part of town is the best location for your development. You contact the finest consulting firm in town and have them send their environmental specialist to your site for a resource inventory. After inspection the specialist finds of your 40 acres, 5 are considered wetlands and are in the middle of the lot. In addition, the entire southwest quadrant is considered habitat of the threatened gopher tortoise.

The engineers, architects, and planners all concur that building on this site will require wetland and habitat impacts. The local WMD does not agree with the consultant's habitat line, but after several meetings, a compromise is reached and the wetland is determined to be 6 acres of non-forested wetland. The gopher tortoises can be relocated (with a permit) but it is deemed wiser to preserve their area amongst the 9 acres of wetland mitigation (9 is required because for every acre impacted there must be 1.5 acres mitigated). The agencies agree with this concept.

Although the county permitting process takes longer than planned, adding to the project cost, all permits are granted and the project is constructed. Because nearly 25% of the site is preserved or mitigated habitat, the leased space is restricted and the prospective tenants are wary of the large, open (and initially unattractive) area. The first monitoring of the mitigation area finds intrusion by noxious plants, which require removal. The second monitoring indicates a major failure of the system growth and you are cited for non-compliance with the permit. After further consultant fees, corrective action is undertaken and in the third monitoring report the local WMD accepts the mitigation. The site is not yet fully leased but a buyer (sucker?) offers to purchase the whole project. After all costs are calculated, you find enough profit for a beer and pizza and thank the county, state, and all other heavy-handed agencies for letting you develop this fine tract of land.

## Key Points

The previous descriptions were an attempt to show the extreme ends of the realm of possibilities in the environmental management process. It is important to note that each development situation is unique and each developer needs to do his/her homework before spending dollar one. By becoming familiar with the general processes and all entities involved, a developer can solve potential conflicts before they arise. For example:

- Read over the local land development regulations before selecting a site. They may contain policies not included in a permit but can still delay project completion.
- Assess environmental concerns of the local population. If a development impacts the habitat of popular hunting animal or obstructs the enjoyment of bird watching, citizens may boycott your establishment once completed or interfere with the development process.

- Avoid confrontations with the government agencies. A prolonged dispute over the amount of wetlands present, for example, will only delay completion and even if you win, you also lose (in most cases).
- Attempt to pre-determine the exact amount of developable land available in the worst-case scenario. In almost every situation, the regulatory agency will attempt to have you preserve or mitigate as much as possible.
- If you have a large development, impacting many acres of sensitive areas, try to sway the public to your favor. Do this by advertising exactly how you will mitigate the problem, provide a detailed maintenance schedule, and show how the development will be a benefit to the community.

The Growth and Environmental Management Game has a high learning curve and it's difficult to be totally successful the first try; but if you know the rules, play your cards just right, and get a little luck, you can come out on top.