

Special Report



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The Lender's Guide to **Managing Residential Land**

By Dan Flanagan

Managing and maintaining residential land projects requires a unique combination of skills and knowledge. This skill set is considerably different than those required to manage an office building, retail center, or other types of real estate. Failing to fully understand what is entailed in managing residential land can result in significant costs. Worse yet, making the wrong moves can adversely affect the value and marketability of the property. The following provides four basic steps lenders can take to ensure that they are maximizing the value of residential land assets.

Step 1 - Understand What You Have.

The first step in undertaking the management of residential land is gaining a comprehensive understanding of what you have. A thorough review of all available documentation relating to the project must be performed with two main objectives in mind. The first objective is to understand in detail the technical aspects of the project so that a clear plan can be prepared for what can or needs to be done with respect to management, maintenance and disposition. The second objective is to identify if there are any significant or critical problems or flaws with the project that need to be addressed or resolved.

A review of physical due diligence information is a critical first step in this process. This includes a review of soil boring and geotechnical information, as well as review of other issues such as wetlands, floodplain, threatened and endangered species, title, and survey, as well as others. Soil issues can be a significant issue on either raw land or partially improved projects, and must be given close scrutiny in this process.

Project entitlements and approvals must also be examined, with an eye to understanding where the property stands in the approval process, whether there are any approvals yet remaining, and what is allowed or required to be done. This process includes a detailed review of zoning restrictions or requirements from the municipality, a review and analysis of any annexation agreements or development agreements, and a review of plats or approved land plans.

The status of improvements and utilities for the project must also be considered. It is important to understand what improvements have been completed as well as what, if any improvements remain to be finished. The conditions and quality of work of any completed improvements is also important to consider, as well as whether adequate sewer and water capacity for the project are available or have been reserved. Finally, many developers are required to complete offsite improvements, such as road improvements or sewer and water system extensions or upgrades. These costs can be significant and can have a dramatic impact on the viability of a project.

An estimate of costs for remaining improvements should also be prepared. Most costs for land development are heavily impacted by the price of petroleum – plastic pipe, diesel for heavy equipment, asphalt. Cost increases over the past few years have been very high so estimates that are more than a few months old should no longer be considered accurate. In some cases, the costs for completing improvements may be so high that the project as designed is no longer viable.

A review of the Homeowners Association (HOA) should also be performed to understand whether it has been set up, what is required, and whether it is operating properly. It is also important to know who is responsible for enforcing the requirements of the HOA. If there are restrictions in the HOA, especially architectural restrictions, it is necessary to understand if they are consistent with current and likely future market conditions.

Understanding what you have may also mean reviewing the value of the property. However, conventional methods of valuation may no longer be meaningful. In today's new world in which affordability reigns supreme, a different approach is needed. A better way to determine value today is to underwrite the property from the standpoint of a builder or developer/investor. This will require an evaluation of current market conditions both in terms of home prices and sales rates, an understanding of the costs required to improve and carry the property, current costs and margins in homebuilding, expected length of time the property will be carried, and expected rates of return for equity investments. In determining home prices, it is imperative to consider median income levels, prices of existing homes in the area, and the amount of home that the median income earner can afford within the marketplace. With the elimination of non-conventional financing, pricing of many projects will need to be re-evaluated in order to make them viable. Undertaking this analysis will provide a clearer understanding of what the property is likely worth today and in the near future.

Step 2 - Manage The Property To Avoid Unnecessary Costs.

In order to maintain and maximize value, residential land requires active management, regardless of whether it is improved or unimproved. Although a raw parcel of land entails less management, there are certain obligations and requirements that still need to be undertaken. If the property does not have any improvements completed, it is generally wise to farm the property in order to try and minimize property taxes.

Some approvals, permits, and entitlements may have a finite life or expire after a certain time. Allowing them to expire without renewal could have a significant adverse impact on property value. On any project that has received approvals or permits, it is important to properly maintain or renew them and not allow them to expire.

Partially or fully developed projects require more intensive management, much more than simply mowing the grass. Further, simply sitting idle and waiting may seem like a good idea on paper, but may come with a number of drawbacks. Sitting still ties up valuable capital that can often be put to more productive uses. In addition, an idle project often results in a negative public perception which can decrease the marketability and value of the property. In addition, the market for residential land is undergoing rapid and drastic changes. Failure to adequately respond to these changes in a proactive manner may have detrimental impact on the project. Finally, many lenders, builders and developers are hoping that the residential market will "turnaround" in the near future so that they can recover some of the lost value of the project. However, based on our analysis the market is not likely to return to the levels observed in the past few years for many years, if at all. And, it is becoming clear that when it does return it will look markedly different than the market we have seen in past years.

Even if the decision is made to sit tight and hope for a better market, there are still obligations that must be met. Nearly any project which results in a disturbance to the land will require a permit for storm water pollution prevention and management. These permits do expire over time and must be renewed. Storm water pollution prevention permits require the use of "Best Management Practices" to prevent impacts to storm water. Enforcement of erosion control requirements is becoming a major issue that requires a concerted effort to manage and address. Many areas now perform periodic inspections of erosion control efforts on sites, and will issue citations for improper management or maintenance. U.S. EPA can issue citations and large fines if they observe a violation.

Completed improvements must be accepted by and turned over to the village or city or applicable government entity. In many cases the village or other governmental entity will prepare a punch-list of items that need to be repairs or fixed prior to turnover. Understanding what is required for acceptance and turnover, as well as the status of the bonds or letters of credits is an important part of managing and maintaining projects. Maintaining completed improvements in good condition requires an ongoing effort in order to minimize costs for repairs at turnover.

Property taxes on partially developed land can add up quickly. Although Illinois Law allows some tax reductions for a developer of raw land, the exemption may not apply if the owner is not actively involved in the completion of improvements to the property. This may present a dilemma for property owners that want to simply sit and hold the property.

Step 3 - Enhance Or Create Value.

In addition to understanding what you have and managing the property as efficiently as possible, in a competitive and challenging market environment it is also important to do what you can to enhance or create additional value in the project.

The housing market is in the process of adjusting to several key factors that need to be considered in every project, including a more competitive homebuilding environment, higher energy prices, more stringent financing, and a return to fundamentals with respect to affordability and financing. As the market changes and readjusts, it is more important than ever to take a careful look at the assumptions made in originally designing a project. What may have worked at the peak of the market may no longer provide the best value for the property in the future, and a significant readjustment may be necessary not only to enhance the property, but to simply make it viable under the changing market conditions.

Some of the factors that may be considered for value creation (or preservation) may include modifying the proposed amenities, enhancing the appearance of the project, or modifying the current land plan. In some cases, it may be worth or even necessary to approach the municipality to seek a reduction in obligations in order to make a project more competitive. In some cases, it may be necessary to scrap existing plans and proposals altogether and completely overhaul a project in order to make it viable.

Municipal fees also need to be understood because they can impact the desirability of project, especially in a more competitive market place. Several municipalities in the Chicago area have adopted impact fees totaling more than \$25,000 per home. Projects in these high fee communities may have a difficult time in the future competing against projects in other nearby communities with lower fees.

Poor appearance or a lack of maintenance may result in a public perception that the project is failing, resulting in the project becoming "tainted." Poor appearance or apparent distress will almost always make sales more difficult. Often minor items that enhance the overall appearance of a property can provide a high level of value. Properly positioning the property against nearby competition is also critical to enhancing or creating value, especially for projects located in a highly competitive area, or in an area where there are numerous distressed projects.

Step 4 - Position The Property For Disposition.

All of the tasks above must be completed with the common goal of making the property as attractive as possible for disposition.

A strong sales strategy starts with an understanding of who is most likely to be the buyer and why. Will the project be sold in bulk to a single builder, or will it be open for individual lot sales or small blocks of lots. Is the builder likely to be a custom builder, production builder or combination of the two? A bulk sale will generally result in a lower sale price but faster sell out of all of the lots, while higher prices and a slower sale pace can be expected with a lot sales program. Which disposition strategy will add the most value requires a solid understanding of the prices and rate of sales that can likely be achieved for the project. Bulk dispositions are becoming rare as builders seek to avoid holding large land inventories, so it may be necessary to look at alternative structures for lot sales, such as multiple takedowns or structured sales programs.

Proper positioning and marketing of the property is also critical for a successful disposition. A high quality marketing package that contains the information necessary for a builder or developer to accurately evaluate the project can have a big impact on whether marketing efforts are successful or not. In a recent sale of a property, the company handling the sale of the property had failed to include one key piece of information on the property in the marketing materials. Because the company was not experienced in developing or selling land, they were not able to provide an adequate answer regarding this issue. This simple oversight made it nearly impossible for prospective purchasers to arrive at an estimate of what they could afford to pay for the property, resulting in considerably lower offers for the property. In this case, one simple oversight may have reduced the prices offered for the property by as much as 20%.

Flanagan Realty, LLC is a real estate brokerage and advisory company focusing on land-related issues. Dan Flanagan, the founding principal and managing broker, has extensive experience in land acquisition and disposition, market analysis and strategy, entitlements, and financial analysis for farmers, land investors and developers, home builders, lenders, and property owners. Our experience and capabilities include residential, farms, commercial and industrial land, as well as special use land sites such as Brownfields, quarries, and power and gas facilities. If you are seeking to acquire or sell land, or are facing other land-related problems, we can help transform your challenges into opportunities.

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