The Development Puzzle

October 24, 2012

Today’s Goals

Sources

Developer Underwriting

Lender Underwriting

Lender Process

Development and Lending Risks

Questions (…and maybe even some answers)
Financial Sources

- Choosing right sources of capital
- Be thoroughly prepared before approaching lenders and investors

Equity – “Risk Capital”

- Developer Equity
- Joint Venture Equity

Debt – Superior position to equity holders

- Insurance
- Securitized Lender
- Commercial Bank

Equity

Equity financing represents the personal investment of the owner (or owners), and offers the advantage of not having to be repaid with interest.

Investors look for:
- Competent management
- Competitive edge
- Growth industry – high risk and high return
- Visible exit strategy

Developer Equity

Outside investors and lenders expect business owners to put their own capital into business before they will invest their own capital. Rule of Thumb: 10%

Joint Venture Equity

- Most venture capitalists seek investments in companies with high-growth and high-profit potential
- Business plans are subjected to an extremely rigorous review
- Most venture capitalists take an active role in managing the companies in which they invest
- Require a higher return to compensate for higher risk. Industry return: 15%
Debt

**Insurance:**
- Term - 3-10 years
- Rates:
  - 2.5% for short term loans
  - 3.5-4% for 5-7 year terms
  - 4.0-4.5% for 10 year terms
  - 60-70% LTV maximum

**Securitized Lender:**
- Term - 10 years
- Fixed Rates - 4.5-5.5%
- Non-recourse
- Servicer issues after closing
- More flexible structuring

**Commercial Bank:**
- Relationship Lender
- Full or partial recourse usually required over 50% leverage
- Floating or fixed interest rates/1-5 years typically
- 25 year amortizations
- Leverage up to 75%
- No prepayment penalties
- Debt service coverage 1.25

Developer

**Underwriting**

“Merchant” – quick turn of equity
Long Term – cash flow/IRR focused
Fee – no equity at risk
NOI and Net Cash Flow

- Net Operating Income (NOI)
  - Income after expenses, but before debt service
- Net Cash Flow
  - Annual cash flow after all expenses and debt service

Example:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Annual Rent</td>
<td>$475,000</td>
</tr>
<tr>
<td>Less: Expenses</td>
<td>$140,000</td>
</tr>
<tr>
<td><strong>NET Operating Income</strong></td>
<td><strong>$335,000</strong></td>
</tr>
<tr>
<td>Less: Annual Debt Service</td>
<td>$235,000</td>
</tr>
<tr>
<td><strong>NET Cash Flow</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>
Return on Cost
(Constant Against Cost) / (Lease Rate Constant)

• The all cash return on cost:

\[
\frac{\text{NOI}}{\text{Cost}} = \frac{\$335,000}{\$3,610,000} = 9.28\%
\]

• The all cash return on investment:

\[
\frac{\text{NOI}}{\text{Sales Price}} = \frac{\$335,000}{\$4,600,000} = 7.28\%
\]

Capitalization Rate (Cap Rate)
Capitalization Rate (Cap Rate)

- Difference between Cap Rate and Return on Cost
  - 100 basis points = 1%

Previous Example:
- Return on Cost: 9.28%
- Cap Rate: 7.28%
- Spread: 2.00%

$\text{Spread} = 200 \text{ basis point spread}$
**The Proforma**

**Short Form**

A development proforma is an organized and researched estimate of income, expenses, costs and loan underwriting, profit and ROE (return on equity).
Efficient office buildings should have a 4%-6% "loss" factor.

Parking Ratio - Market ratios for suburban office can range from 3.5:1000-7:1000 for high density call centers. Higher parking requirements may require additional municipal reviews and approvals.

FAR – Floor Area Ratio. A measure of site density/efficiency. Impacted by site configuration, parking ratio, open space requirements, etc.

Rent Escalations – annual income growth can be important to your investors and lenders.
### COSTS PER RENTABLE
Calculation of certain fixed costs over the rentable area of the building.

- **Taxes**: Interim taxes owed on the property prior to Tenant occupancy. Learn your site’s mill levy and if your county has interim valuations.
- **Environmental**: Can be a significant project risk. Determination of environmental testing, remediation, and possible insurance will be critical for lender and sale underwriting.
- **Surface parked suburban office land**: Should generally run $20-$25 per rsf.

### Title/Closing
Title insurance is purchased to indemnify loss or damage resulting from defects or problems relating to the ownership of real property, or from the enforcement of liens that exist against it.

### TI ALLOWANCE
A negotiated allowance provided to Tenant for design and construction of its improvements. Can also be applied towards cabling, move-in, legal, etc.

### Government Charges
Utility deposits, entitlement fees, plan reviews, tap fees necessary to obtain municipal approval and bring utility services to the building.

### Example Table

<table>
<thead>
<tr>
<th>Land</th>
<th>Sold</th>
<th>Total</th>
<th>Cost per R.F.</th>
</tr>
</thead>
<tbody>
<tr>
<td>LAND</td>
<td>$26,760</td>
<td>$32,160</td>
<td>$1,500,200 allowance</td>
</tr>
<tr>
<td>S.T. TEST</td>
<td>-</td>
<td>-</td>
<td>$5,500</td>
</tr>
<tr>
<td>ENVIRONMENTAL INVEST</td>
<td>-</td>
<td>-</td>
<td>$25,000</td>
</tr>
<tr>
<td>CLOSING &amp; TITLE</td>
<td>-</td>
<td>-</td>
<td>$10,000</td>
</tr>
<tr>
<td>R.E. TAXES</td>
<td>-</td>
<td>-</td>
<td>$250,000 allowance</td>
</tr>
<tr>
<td><strong>TOTAL LAND COST</strong></td>
<td>$32,160</td>
<td>$35,500</td>
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</tr>
</tbody>
</table>

### Building Table

<table>
<thead>
<tr>
<th>Building Shell &amp; Core</th>
<th>Unit</th>
<th>Unit Price</th>
<th>Total Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.S.C.</td>
<td>$844,857</td>
<td>$710.00</td>
<td>$7,956,667</td>
</tr>
<tr>
<td>SITE ALLOWANCE</td>
<td>-</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>SITE IMPROVEMENTS</td>
<td>$28,797</td>
<td>$4,750</td>
<td>$138,475 allowance</td>
</tr>
<tr>
<td>ARCHITECT/ENGINEERING</td>
<td>$336,145</td>
<td>$5,750</td>
<td>$5,750</td>
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<tr>
<td>UTILITY FEE/COUNTY</td>
<td>-</td>
<td>$375,000</td>
<td>$375,000</td>
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<tr>
<td><strong>TOTAL BUILDING COST</strong></td>
<td>$1,278,715.25</td>
<td>$147.61</td>
<td>$1,278,715.25</td>
</tr>
</tbody>
</table>

### Lease language should be structured to maximize how much of Tenant’s allowance must go “into” the building.

### TAUNOWANCE
A negotiated allowance provided to Tenant for design and construction of its improvements. Can also be applied towards cabling, move-in, legal, etc.

### Tap Fees will generally comprise 75% or more of the government charges budget.
Interest Carry: Generally calculated by development of a construction cash flow, which will determine accrued interest during project construction. “Calculation of interest through occupancy only”

Commitment Fees: Lender charges for origination, administration, lender legal, etc.

If bringing outside equity to the transaction, your partner may also have an “equity placement fee” (generally 0.5% = 1% of equity contributed)

The short form proforma uses a formula, which is generally a fairly accurate estimate.

<table>
<thead>
<tr>
<th>LAND INTEREST</th>
<th>x</th>
<th>5.59%</th>
<th>=</th>
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<tbody>
<tr>
<td>$1,060,200</td>
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<td>$58,827</td>
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<table>
<thead>
<tr>
<th>CONSTRUCTION INTEREST</th>
<th>x</th>
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<tr>
<td>$10,512,240</td>
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<td>$592,088</td>
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<table>
<thead>
<tr>
<th>COMMITMENT FEES</th>
<th>x</th>
<th>1.25%</th>
<th>=</th>
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<tbody>
<tr>
<td>$21,414,450</td>
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<td></td>
<td>$268,146</td>
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</table>

TOTAL E & I COST: $500,442

<table>
<thead>
<tr>
<th>DEPLOYMENT</th>
<th>B.R.F</th>
<th>PER B.R.F</th>
<th>COST</th>
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<tbody>
<tr>
<td>COMMISSIONS</td>
<td>$100,000</td>
<td>$100</td>
<td>$100,000</td>
</tr>
<tr>
<td>DEVELOPMENT</td>
<td>$16,000,000</td>
<td>$400</td>
<td>$6,400,000</td>
</tr>
<tr>
<td>MARKETING</td>
<td>$70,000</td>
<td>$70,000</td>
<td></td>
</tr>
<tr>
<td>LEGAL</td>
<td>$50,000</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>CONTINGENCY</td>
<td>$500,000</td>
<td>$500,000</td>
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TOTAL DEVELOPMENT COST: $121,474

<table>
<thead>
<tr>
<th>MARKETING</th>
<th>B.R.F</th>
<th>PER B.R.F</th>
<th>COST</th>
</tr>
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<tbody>
<tr>
<td>TOTAL PROJECT COST</td>
<td>$233,446</td>
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<table>
<thead>
<tr>
<th>DEVELOPMENT</th>
<th>B.R.F</th>
<th>PER B.R.F</th>
<th>COST</th>
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<tr>
<td>CONTINGENCY</td>
<td>$500,000</td>
<td>$500,000</td>
<td></td>
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TOTAL DEVELOPMENT COST: $121,474

Commissions: Fees charge by Tenant and/or Landlord representatives in the project. Developer generally pays all leasing commissions for a transaction.

Rates typically charged either per mf or based upon a percentage of net rent.

Development Fee: Developer’s charge to the project to cover overhead, administration, and fee-based profit.

Developer Fees vary by the transaction, but are generally 3%-5% of total project costs.

Marketing: budget for post-award marketing activities, including any collateral development, groundbreaking/ribbon cutting ceremonies, press events, neighborhood outreach, client gifts, etc.

Legal: Developer’s attorney fees for land acquisition, title/survey review, lease negotiation, sale negotiation, easement drafting, condo formation, etc.

You should generally carry 2%-3% of the project budget as contingency.

Contingency: Developer’s project level contingency (in addition to General Contractor’s hard cost contingency).
Project Cost $ X Lease Rate Constant = Initial Year Base Rent

BTS rental rates are generally calculated as “NNN”, with Tenant taking responsibility for all operating expenses, taxes, etc., subject to negotiated caps.

Factors in determining constant - **everything that impacts exit value**: Tenant credit, lease term, interest rate, termination options, opex risk, rate in comparison to market.....

NOI / Cap Rate = Project Value

A Developer’s biggest risk - **and biggest reward** – is tied to cap rate movement.

Sales Commission - broker fees, etc., associated with the marketing and sale of the asset. Generally cannot be included in project costs for the purposes of calculating rent.
Quick Math Technique

- Use 10% as a general developer required return on cost

Example – Suburban Office

$18.00/sf/yr NNN Market Rent

$180.00/sf Maximum Developer’s Cost

Cap Rate = $1,723,957 $21,549,460 $1,723,957 $20,281,845 = 8.50% 8.00% = 50 Basis Points

Margin = $21,549,460-$20,281,845 = $1,267,616
6 C’s:

1. **Cash Flow of the Borrower** – Primary source of repayment - cash flow of business; secondary source of repayment – personal cash flow of guarantors

2. **Credit History** – Past repayment history

3. **Collateral** – Sufficient collateral to secure loan must be demonstrated

4. **Capacity** – Ability of Borrower and Guarantor to handle loan request from a leverage and coverage standpoint

5. **Character** – Management history and experience in the industry

6. **Conditions** – Anticipated effects of the economy on company’s repayment ability
Lender Due Diligence

Credit
- Developer/Guarantor
  1. Experience
  2. Financial Capacity (Tier 1 & Tier 2)
    A. Net Worth
    B. Liquiditiy
    C. Contingent Liabilities
    D. Recurring Cash Flow (Global Cash Flow)
    E. Adjusted Gross Income
    F. Review Real Estate Schedule

- Tenant
  1. Investment Grade vs Non-Investment Grade Tenants
  2. Years in Business
  3. Profitability (YTD #’s & Historical Operating #’s)
  4. Liquidity

- General Contractor
  1. Experience/Resume/Reputation
  2. Profitability/Bondable

Various Loan Metrics
- Loan To Cost (LTC)
  1. Loan to Acquisition Cost (including cost of transaction)
  2. Loan to Construction Costs (inclusive of developer fees and financing fees)

- Loan To Value (LTV)
  1. Loan to “As Stabilized” Value
  2. Loan to “As Is” Value

- Debt Service Coverage (DSCR)
  NOI/Debt Service = DSCR
  NOI/Debt Service = DSCR (Using Current Rate and Amortization)
  NOI/Debt Service = DSCR (Using Permanent Underwriting guidelines)

Note: Permanent Underwriting standards would include: “Net Operating Income (NOI) provides for a 1.25 DSCR based on: trailing 12 month rental income, a 30 year amortization and the greater of i.) actual rate, ii.) 5.5% rate; or iii.) the then 10 year Treasury + 250 bps

- Debt Yield (DY)
  NOI/Loan Amount

Third Party Reports/Market Study
  1. All Appraisals must be ordered by financial institutions
  2. Property Condition Assessment (PCA)
  3. Environmental Report (Phase 1)
  4. Plan and Cost Review
  5. Feasibility Study (Market Study)
Lender Due Diligence

**Loan Documentation:**
-- Three years historical financial statements and tax returns.
-- Personal financial statements on owners and three years personal tax returns.
-- Use of proceeds – what is loan request for?
-- Collateral to be used to secure loan.
-- Projected cash flow of business showing ability to repay.
-- Resumes on key management personnel.
-- Business plan

**Guarantees:**
-- Recourse Carve-Out; Environmental; Completion.

**Collateral Assignment:**
-- All development contracts assigned to lender as collateral.

**Draw Process:**
-- Draw request will include documents to be submitted by borrower – (i) lien waivers from contractors/sub-contractors, (ii) invoices for work performed, (iii) reconciliation of draw requested to construction budget, (iv) inspection or confirmation from project engineers that work is completed and (v) evidence that no mechanic’s liens of record against property.

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**Risks**

- Contractor Bankruptcy
- Weather Delays
- Labor/Material Shortages
- Interest Rate Increases
- Cap Rate Movement
- Uninsured Casualty