



## WASHINGTON ASSOCIATION OF REALTORS®

Government Affairs - Issue Paper

### *Real Estate Development*

#### **Principles and Process of Real Estate Development**

Real estate development is the continual reconfiguration of the built environment to meet society's needs. Roads, water and sewer systems, houses, office buildings, and festival marketplaces do not just happen. Someone must initiate and manage the creation, maintenance, and eventual re-creation of the places in which we live, work, and play. It is the real estate development process that creates the houses we live in, the office buildings we work in, the stores we shop in, the restaurants we eat in, the schools we learn in, and the parks we play in.

Developers are subject to attack because they engineer change in communities that is sometimes hard to accept. Yet, they provide a service as a community builder. They facilitate the production of shelter for living and working. They make possible new play areas, recreation areas, and health care facilities. And they do this within the rules set by the public sector – planners, government staff, and elected officials.

The need for development is constant because population, technology, and taste never stop changing. Growing populations, new generations, technological and economic changes affect consumer tastes and preferences. Communities are always going to grow and change. With a good developer, that growth can be managed and made to have a positive effect on a community.

*“You can dream, create, design and build the most wonderful place in the world, but it requires people to make the dream a reality.” – Walt Disney*

Real estate development is an idea that comes to fruition when consumers acquire and use the construction put in place by the development team. Land, labor, capital, management, and entrepreneurship are needed to transform an idea into reality. Value is realized by providing usable space over time with certain associated services needed so consumers can enjoy the intended benefits of the built space. The product of the development process – a new or redeveloped building – is a result of the coordinated efforts of many professionals.

Developers assemble the needed talents to accomplish their objective and assume responsibility for managing individuals to make sure that development potential is realized. The development team consists of the developer (who plays interchanging roles as innovator, promoter, leader and manager), architects, engineers, land planners, landscape architects, contractors, construction workers, environmental and transportation consultants, appraisers, attorneys, accountants, real estate professionals, leasing agents, finance partners, investors, construction and permanent lenders, property managers, market researchers, and marketing consultants.

The real estate development process includes financing, planning, building, and marketing. The developer must acquire the land, secure permits, prepare site plans, prepare building plans and specifications, obtain or provide access to infrastructure, prepare the site for construction (grading, extending streets and utility lines to building site), and building construction (material and labor).

Developers follow a sequence of steps from the moment they first conceive a project to the time they sell or lease the project. Development requires coming up with an idea, refining it, testing its feasibility, negotiating contracts, making formal agreements, constructing the project, completing and opening it, and selling, leasing or managing the new project. The developer's job description includes shifting roles as creator, promoter, negotiator, manager, leader, risk manager, and investor. Developers must design, finance, build, lease or sell, and manage their project.

In order to just get the project started, the developer will invest significant time and money before the project is approved for financing and by public entities.

Development requires extensive knowledge about prospective markets and marketing, patterns of growth, legal requirements, local regulations, public policy, conveyances and contracts, elements of building design, site development and building techniques, environmental issues, infrastructure, financing, risk control, and time management.

In choosing a site to develop, several factors must be considered, including: size and shape of site for the intended use, site location and proximity to infrastructure and natural amenities, ease of development, improvements needed for site development, site design, relation to surrounding sites, restrictions to development, site constraints, regulations, timing, marketability, cost of construction, potential sales price, and project feasibility.

Once a potential project site is found, the developer must conduct a location analysis to determine the site's accessibility, zoning, utility availability, growth path/trends, and environmental considerations. Market and economic studies provide the developer with necessary information that includes an appraisal, cost-benefit analysis, analysis of economic base, analysis of economic impact, study of highest and best use, land use study, market study, marketability study, and financial feasibility analysis. Economic and demographic data are needed to determine the area's employment, population, households, income, price of space, and users' expectations.

Developers, planners, public officials, lenders, and investors use market and feasibility studies to make better-informed decisions about property development. Developers use market research to make decisions at several stages in the process to answer several questions. The market study (used for idea, design, financing, public approval, promotion and marketing) looks at the primary market, trends, supply and demand, competitive analysis, identifies market niche, market conditions, competition, employment growth rate, household growth rate, type/size of housing, market absorption (number of units, price, time period), what percent of the market the project is expected to capture and why, target audience, how to market the product, regulatory requirements, and public attitudes.

The developer must develop a site plan, which considers natural amenities (trees, water features, rolling hills), constraints (flood plains, wetlands, steep inclines), traffic patterns, allocation of open space, locating on-site uses and amenities, transitions, and appearance.

Developments do not happen without financial backing. The developer must consider the development costs, and will need financing for land acquisition and improvements, infrastructure, construction (labor and materials), financing, fees, and overhead. The financial market further plays a role through permanent (mortgage) loans. The developer and financial partners look at feasibility studies to determine if the estimated value will exceed the costs of development. In determining whether to finance any project, the financial institution must determine economic feasibility utilizing market analyses (demand, supply, timing), land analyses, real estate analyses (site, size, shape, topography,

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use, zoning, utilities, deed restrictions, development agreements, regulatory, improvements), collateral analyses (securing loan using asset value), property management analyses (plan and experience), feasibility analyses (determining if the project pencils out, underwriting the project, determining loan amount based on loan-to-value ratio or debt coverage ratio), and loan placement analyses.

Only then can construction be started, involving design professionals, construction workers, engineers, and many others. Before, after, and during the process, the developer is working with public officials on approvals, zoning changes, exactions, building codes, infrastructure and the public participation process. Increasingly, community groups are key players in the development process, and the time needed to work with them needs to be factored into the development equation. And, finally, being able to sell or rent the space to users requires the expertise of marketing professionals and sales people. The developer must ensure that all of these elements are completed on schedule, are properly executed, and are reasonably within budget.

A great deal of uncertainty is associated with the development process. Developers must balance an extraordinary number of requirements for completing a project against the needs of diverse providers and consumers of the product. Developers need the blessing of local government and neighbors around the site. Often, to obtain public approval, developers are required to re-design the project.

Real estate developers have a public sector partner in every deal – no exceptions – whether or not they choose to recognize that partner. Government – federal, state, and local – permeates the system of capitalism under which developers operate. Real estate development is a highly regulated process. Taxes, labor law, property law, public infrastructure, financial market operations, zoning, building permits, public health and safety, environmental laws, land use restrictions, and impact fees all derive from legislation, regulations, and public policy. If developers do not work hand in hand with local governments, giving them the same amount of respect and attention they would give a private sector partner, delays and problems often occur.

The public and private sectors are involved as partners in every real estate development project. The private sector's goals are to minimize risk of their investment while maximizing profit, and enhancing their professional reputation. The public sector's goal is to promote sound development, ensuring that construction is attractive, safe and conveniently located to help the community function well. Quality development means balancing the public's need for both constructed space and economic growth with the public responsibility to provide services and improve the quality of life without harming the environment.

Government regulators should strive to produce a fair, efficient, flexible, predictable system for allocating land uses and spurring quality development. If regulators understand all the pressures on the development and how they relate to both public and private objectives, they will be more likely to support the project and less likely to delay the development approval process.

As part of the comprehensive planning goals, each community should strive for a partnership with the real estate and development interests to work toward common goals and find ways to make projects profitable to the developer and beneficial to the community. It is important for regulators to recognize the constraints of developing projects. Likewise, it is important for developers to understand community goals. When regulators come to the table with an attitude to find a way to make the project work, and developers come to the table with an attitude of achieving community goals, the process will proceed smoothly.

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Developers should also not overlook the people in the neighborhood who will be directly affected by the project. Time is money in real estate development. Overlooking or antagonizing public partners ultimately costs the developer time, which translates into interest payments and other costs. More important, the public sector can delay the developer and can even change the rules in the middle of the game.

Changing the plan and/or design midstream is usually much more expensive. In fact, changes forced by the public sector can make a project infeasible. When this happens at a later stage in the development process, developers often face almost insurmountable difficulties. For these reasons, it pays for private developers to treat the public sector as a partner in the process from the outset.

**Summary:** The residential real estate industry is an inherently cautious industry. Most homebuilders are small, local businesses, operating with low margins. Homebuilding has so many inherent risks that the builder must plan very carefully in order to minimize risks and ensure margins for the unexpected. A project must pencil out based on the best available market information and on accepted industry principles such as the ratio of land price to unit sales price.

Homebuilders respond to a demonstrated need of people for homes. Most homebuilders do not think of themselves as being in the business of implementing land use plans or community visions. Markets, not community plans, point to opportunity and determine success. Once builders identify overall demand in an area they look at what potential customers in that market can pay. Anticipated sales prices or rents will determine unit size and the features and amenities the builder can add. The wider the type of housing types allowed, the more ways a builder can find to meet customer demand.

Builders only make money when they sell their units, or begin to receive rent from them. The builder's personal income is embedded in the project, and this income can vanish quickly if costs rise. Banks, contractors and suppliers must get paid first, so the builder's livelihood tends to come last. As a result, the builder will make every effort to load all costs, including fees levied by local governments, onto the final customer.

Once a builder has committed to a project, delays in getting permits to build can easily jeopardize the project. The builder must carry the additional costs of financing land and up-front design and development work. Timing is everything. The builder needs to know when to commit scarce capital, when to gear up for construction, when to sign on sub-contractors, when to initiate other projects and how to keep the cash flowing to cover overhead. When sales income is pushed further into the future, either prices must rise or profits will be eaten up.

If economic or regulatory conditions become too difficult, homebuilders often cease to build new homes, opting instead to look for new opportunities. Communities that want to attract new and innovative developments or want to expand housing in slow markets can do two things to entice builders and buyers: mitigate risk