



RE STRATEGIC SOLUTIONS, LLC

**Developer Profit/Incentive
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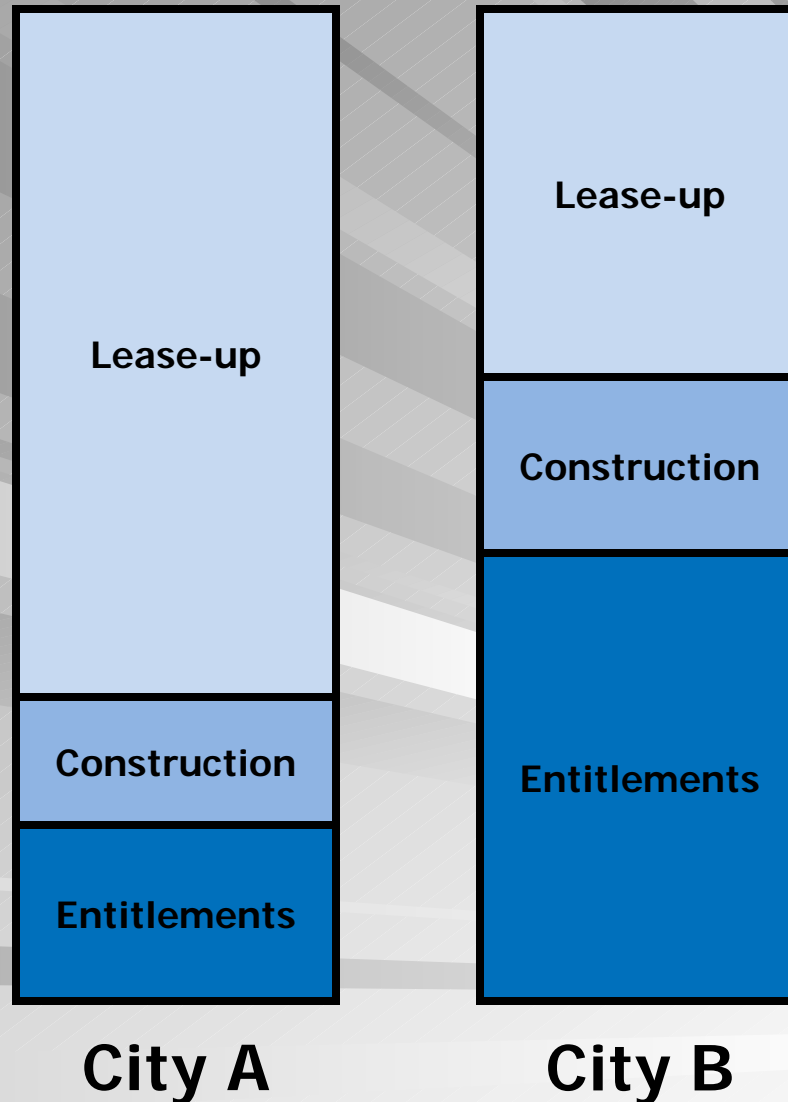
Developer Incentive

- *Compensation expected in the market to motivate a developer to undertake development*
- *Incentive is anticipated or forward looking*

Developer Profit

- *Compensation actually received by a developer for undertaking development*
- *Profit is historical or backward looking*
- *Market, incl. appraisers, uses incentive and profit interchangeably*

Allocation of Developer Profit/Incentive



How to Measure Profit

■ ***Development Profit = (Sale Price - Dev'l Cost) / Dev'l Cost***

Note: Development Cost through completion include land cost. Development Cost through stabilization additionally include leasing costs and operating losses through stabilization.

Example: How to Measure Profit

- *Development Cost when completed (incl. cost of land) = \$740,000*
- *Dev'l Cost through stabilization (incl. leasing costs and operating losses through stabilization) = \$820,000*
- *Sale Price if sold upon completion = \$777,000*

Therefore, Profit at completion = $(\$777,000 - \$740,000) / \$740,000 = 5\%$

How to Measure Profit, cont.

■ ***Sale Price if sold upon stabilization = \$943,000***

***Therefore, Profit at stabilization =
(\$943,000 - \$820,000) / \$820,000 =
15%***

Allocation of Profit

- ***Profit for Completion = 5%***
- ***Profit for Lease-Up to Stabilization = 15% - 5% = 10%***
- ***Total Profit through Stabilization = 15%***

What if profit cannot be measured?

- Sales Prices cannot be confirmed**
- Development Costs cannot be determined**

Appraiser must rely on interviews

Interview Questions

- ***What % or \$ was expected and/or rec'd?***
- ***If % of something, what is something?***
- ***If DCF used, then ask if profit is built into a Yield rate, or is a separate line item deduction, and is the Yield rate a Yo, Yot, Ye or Yet?***
- ***Any in-house costs, e.g. OH included?***
- ***Did project meet expectations/would you do another project for same amount?***
- ***Did project for other reasons? accolades, donative intent, keep staff working etc.***

Incentive vs. Risk

- *Development incentive has to be a function of risk related to the type and scope of the development*
- *Risk is best understood from a market study as part of the highest and best use analysis*

Incentive in Cost Approach

- *% of hard costs*
- *% of hard and soft costs*
- *% of hard and soft costs and land*
- *Fixed \$ amount*

The Market Determines it!

Incentive in Cost Approach

- *Incentive is charged (earned) as of the date of valuation.*
- *Incentive is received when property reaches stabilization, sold, financed or refinanced*
- *If seeking value “as if or when completed”, then incentive needs to be allocated*

Incentive in Income Approach

Context: Using DCF to value “as is” land value or “entitled” land value for a proposed development or “when completed, but not stabilized” value:

- 1. separate line item deduction during entitlement, construction, lease-up and/or sales phases***
- 2. built into Yield rate (Yo, Ye, Yot, Yet)***

Proper method is one used by market

Incentive in Income Approach

1. *Line Item Deduction*

- *% of gross or net revenue***
- *\$ amount***
- *Y reflects only risk of the project***

2. *Included in a Yield Rate*

- *Y includes both incentive and risk***

The Value is the Value!

- *Value is not affected whether or not line item for incentive is included or excluded*
- *if 2 different values result then either Yield rate and/or line item for incentive is wrong*

But, Yield Rate is function of whether or not a line item for incentive is included or excluded

- ***Yield Rate is lower if line item for incentive is included in the forecasted cash flows because Yield Rate then only reflects risk (not incentive and risk)***

Example: Solves for bulk value of subdivision if profit for marketing phase is given

Static Model	
Gross revenue (27 lots @ \$66,000)	\$1,782,000
Remaining development cost	\$0
Marketing (6% of gross sales)	(\$106,920)
Carrying cost & overhead	(\$21,600)
Net revenue	\$1,653,480
Entrepreneurial incentive (18.5%)	(\$330,480)
Bulk/wholesale value (27 lots @ \$49,000)	\$1,323,000
Discount rate	N/A

Example: Solves for bulk value of subdivision if given line item for profit during marketing and discount rate reflects only risk of dev'l.

DCF with Line-Item Incentive

	Months 1-6	Months 7-12	Months 13-18
Gross revenue (9 lots/period @ \$66,000)	\$594,000	\$594,000	\$594,000
Remaining development cost	\$0	\$0	\$0
Marketing (6% of gross sales)	(35,640)	(35,640)	(35,640)
Carrying cost & overhead	(12,000)	(7,200)	(2,400)
Net revenue	\$546,360	\$551,160	\$555,960
Entrepreneurial incentive (10.0%)	(59,400)	(59,400)	(59,400)
Cash flow after incentive	\$486,960	\$491,760	\$496,560
Bulk/wholesale value (27 lots @ \$49,000)	\$1,323,000		
Discount rate (nominal annual)	11.3%		

Example: Solves for bulk value if Yield Rate reflects profit and risk of development

DCF without Line-Item Incentive

	Months 1-6	Months 7-12	Months 13-18
Gross revenue (9 lots/period @ \$66,000)	\$594,000	\$594,000	\$594,000
Remaining development cost	0	0	0
Marketing (6% of gross sales)	(35,640)	(35,640)	(35,640)
Carrying cost & overhead	(12,000)	(7,200)	(2,400)
Net revenue	\$546,360	\$551,160	\$555,960
Entrepreneurial incentive (0%)	0	0	0
Cash flow after incentive	\$546,360	\$551,160	\$555,960
Bulk/wholesale value (27 lots @ \$49,000)	\$1,323,000		
Discount rate (nominal annual)	24.0%		