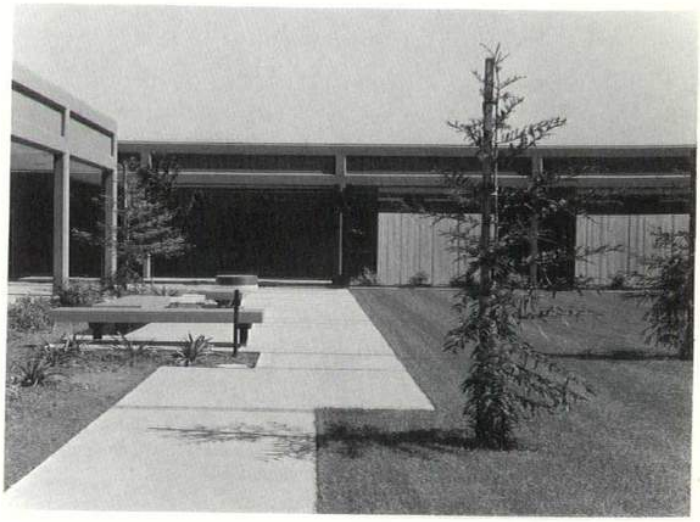
As a result, Law and his partner, Jack Woodson, often work 14 hour days, and most probably it is this enthusiasm that is responsible for keeping this remarkable small office busy in a time of depression when many architects are out of work. In fact, in the past several months, the office has almost doubled in size as new draftsmen are being hired to keep up with the large number of housing projects that are now in process.

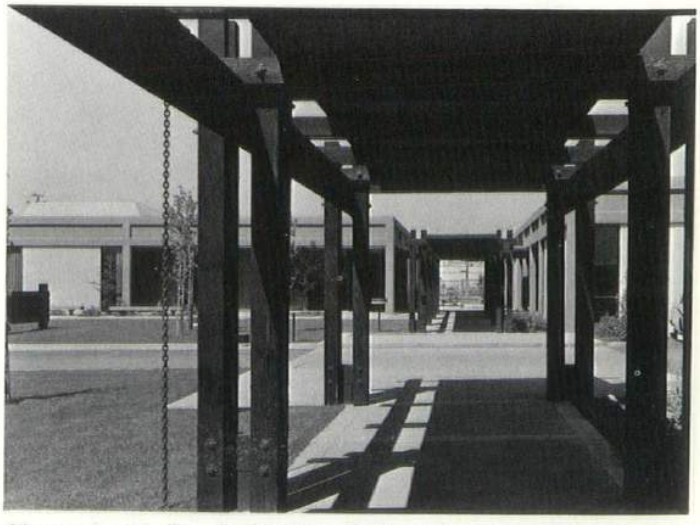
In addition to housing projects, in the last few years, Law's office has designed several tilt-up industrial buildings. A typical project is the complex designed for Sierra Land Company in Mountain View. Each individual building is simple and inexpensive to build ($6/sq. ft.), but a good environment results from the interrelations of the buildings, their indoor and outdoor spaces, and the landscaping. The keynote here is a good master plan so that a good environment can be created without increasing costs.

Law has long been an advocate of systems-oriented design. He is a partner in Housing Systems, Inc. which has built two federally subsidized housing projects for Mexican-American farm-workers, and is now working on its third project. The projects themselves were a success; houses have and are being built for as low as $10/sq. ft. The corporation has made mistakes in financial management, only pointing out more forcefully to Law that the Developer's business knowledge and profit making motive must be incorporated into the architectural field before significant design innovations can be realized. Law is now also a partner in a new low-cost housing corporation, Ecosystems, which was formed just for this reason: "to demonstrate the profitability of creating environments based on ecological considerations," and he has great hopes for it in the future.

Over the years, John Law has come to realize that the men who shape our environment must realize a balance between profit, ecology, and aesthetics, and that one without the other is either unrealistic or harmful. Since the concerns of the architect and the developer must be combined, he concludes that it would be easier for the architect who is already trained in design and ecology to become more sensitive to the developer's profit making considerations than for the developer to pick up on the architect's training. He feels that although most architects envision themselves designing $80/sq. ft. monuments, this is probably only 5% of the work of the future. Today's architect must learn to design what is saleable, profitable, and relevant if the profession is to survive.

The Eberhart Residence, Half Moon Bay, California.





Sierra Land Co. Industrial Buildings, Mountain View, California.

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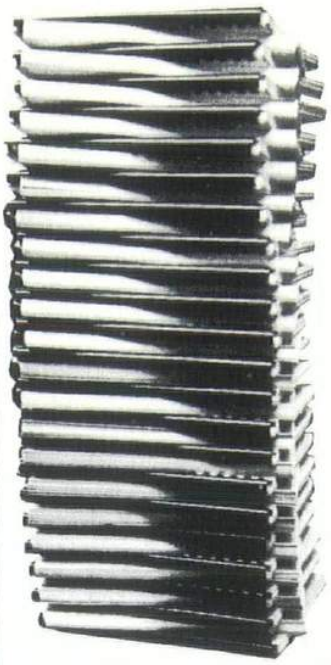

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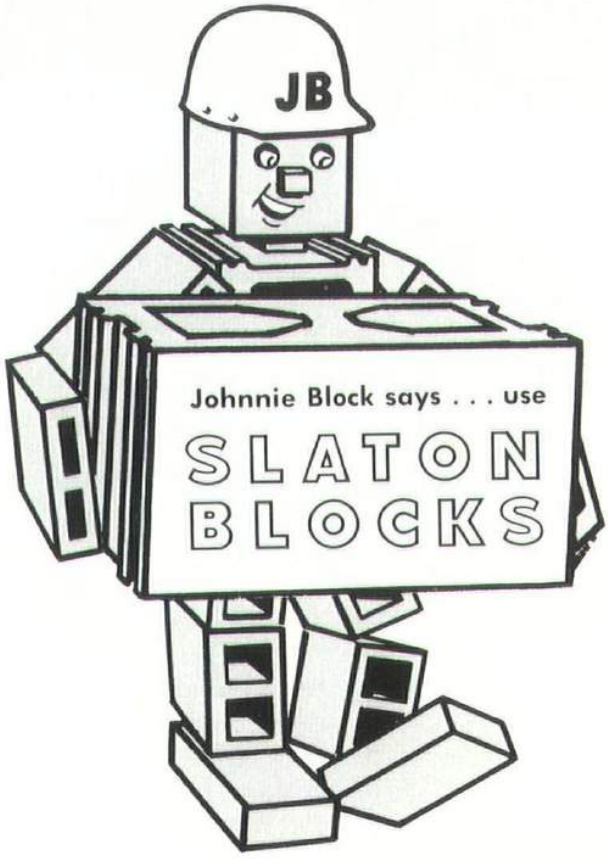
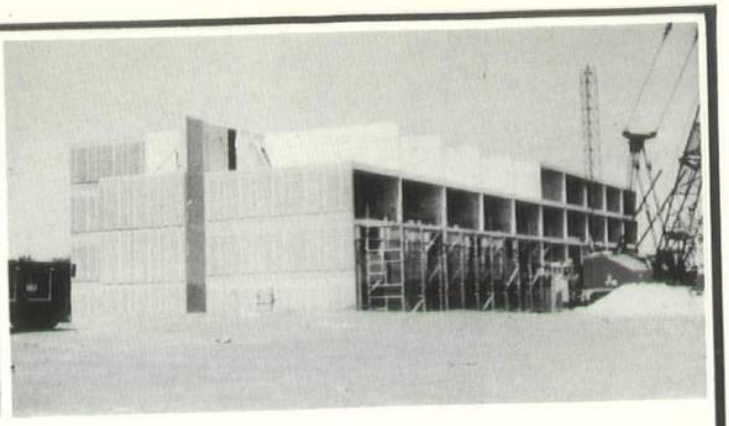
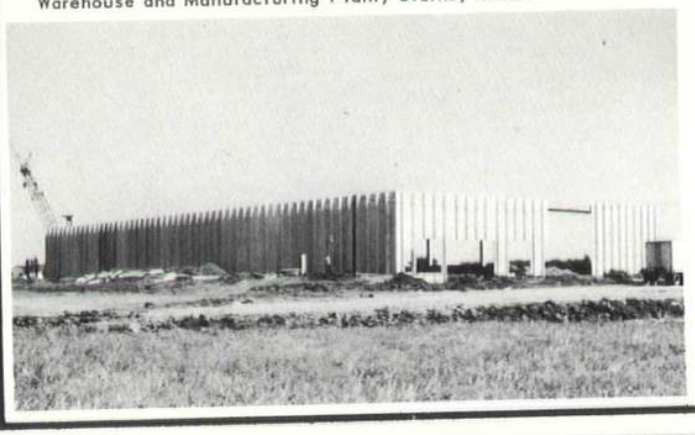




OFFICES: (Above)
Gateway II Office Building, Kansas City, Kans.

APARTMENTS: (Above, right)
Temple Heights Manor, Raytown, Mo.

WAREHOUSES & MANUFACTURING PLANTS: (Below)
Warehouse and Manufacturing Plant, Olathe, Kans.



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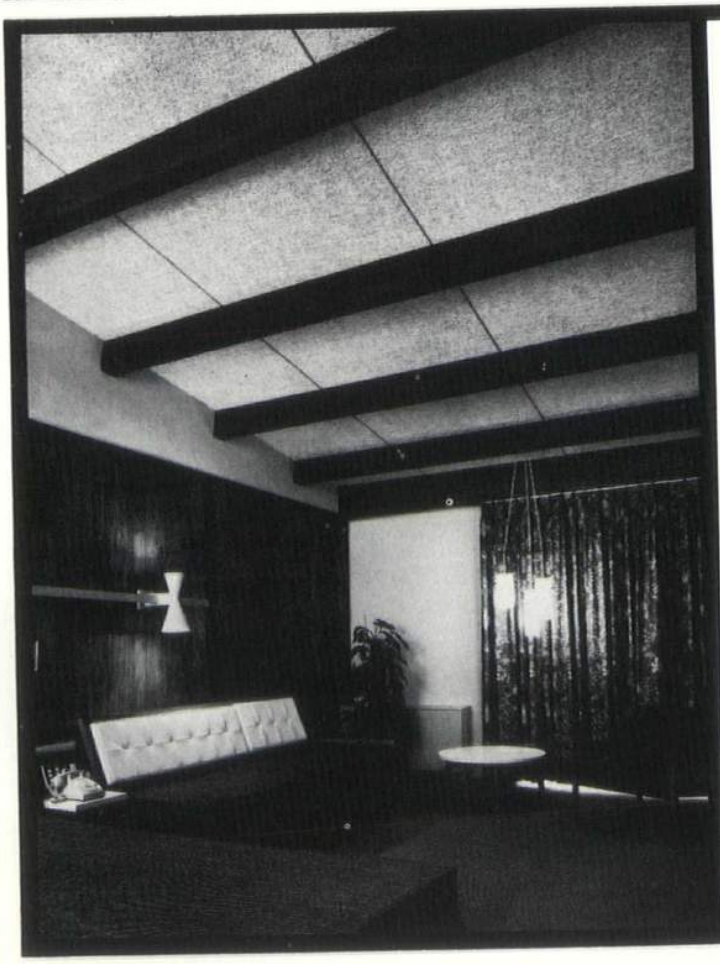

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Friday Afternoon
Paul B. Farrell, Jr., Lawyer, Mortgage Banker, Architect
"Architectural Development Financing — Its Jargon and Meaning to the Architect"

Paul B. Farrell, Jr., is Manager of Project Development for the real estate subsidiary of the City Investing Company, a billion dollar conglomerate with large land holdings throughout the country.

In the spring of 1970 Mr. Farrell was the Chairman of the Building Research Institute's Conference on Construction Management. His experience includes a vice presidency with the nation's largest commercial mortgage banker, assistant to the president of a large architectural/engineering firm, and more recently he taught at Cornell University's Department of Architecture while doing research on new towns' land acquisition strategies for New York State's Urban Development Corporation. He has written and spoken on such topics as the future of the architectural profession, project management, ethics, finances, registration, computers, taxation, and legal responsibilities of the architect. His articles in PROGRESSIVE ARCHITECTURE include "The Architect as a Developer," "The New Environmental Professional," and the following article "Ten Rules for Profits in Land Development," published in the March '71 PA.

Just because the architect can make more money participating in land development than by designing for fees, such speculation does not guarantee easy profits

Is the architect becoming a real estate entrepreneur? A recent survey indicates that about one-third of the architectural firms have actually been involved as principals in at least one land development project. Another third outlined similar plans for the immediate future. The survey included almost 100 large and small firms responsible for an estimated $4 billion of construction annually. As principals, these architects were not merely consultants but also took a "piece of the action" (an equity ownership position in the project) either in lieu of or in addition to their fee. Moreover, it is also clear that these architects were not passive investor-consultants, but rather active decision-makers and co-developers.

This trend toward a more active leadership role in the real estate/construction/architecture business is a healthy sign for the profession. Architects moving in this direction should keep in mind certain operating rules, and also recognize the fact that the successful developer is likely to know when to ignore the rules and often does not fully understand his reasons for acting decisively.

1. Develop a "killer instinct"

Most architects are passive consultants to developers. They lack the entrepreneurial flair — the killer instinct — that drives the developer to make decisions and take risks, acting on incomplete information in an uncertain environment. The developer stands to lose (as well as make) a lot of money. But he enjoys the adventure inherent in real estate development.

2. Protect your position

Often architects will develop concept drawings and agree to accept their fee *if* the project goes ahead. The client's land, however, is probably appreciating in value whether the project gets built or not.

Architects all too often underestimate the value of their contribution, both as a percentage of the seed money (initial capital) required to get the project off the ground, and as the planner of the development concept. The architect should demand more than his basic fee if his risks are greater than normal, or else tie up the client with a partnership agreement *before* making any studies.

3. Reject marginal projects early

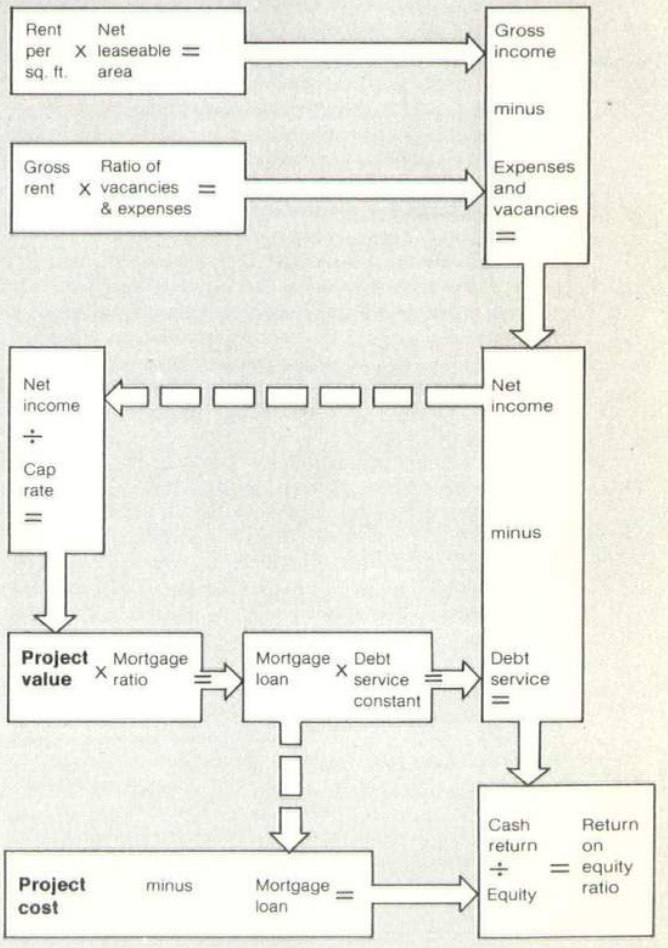
One successful architect regularly but politely turns away many clients after he determines that the project's economics are questionable (the cost will be too high for the rents in that area, the principals are financially weak, or other reasons). He arrives at this conclusion quickly by making his own "ballpark" feasibility study of the project's economics (rule 4).

4. Don't confuse project cost and mortgage value

Value is not a function of cost. A leader does not give a developer $2 million because the project costs $3 million and the lender will lend 67 percent of that amount. If he does get $2 million, it will be because the value of the project is $3 million, not the cost.

Here is one simplified variation of the type of feasibility study commonly used by mortgage bankers in arriving at project value (diagram).

Appraisal for land development



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a. Multiply the rent per square foot times the number of square feet net leasable area to determine the gross rent.
b. Multiply gross rent by the ratio of vacancies plus expenses to determine the vacancy and expense allowance.
c. Subtract the vacancy and expense allowance from the gross rent to arrive at net income.
d. Now "capitalize" the net income: divide the net income by the "cap rate." (Definitions of the rate of capitalization range from esoteric to arbitrary, so just accept your mortgage banker's rate as a fiat from the lenders.) That is, if the net income is $200,000 and the current cap rate for this type of project is 8 percent, the value of the project is $2.5 million. Look at it this way: the lender is telling the developer that he expects a $2.5 million project to throw off a net income of 8 percent.
e. Multiply the project value by the mortgage ratio to determine the amount of the loan.
f. Multiply the loan amount by the debt service constant to determine the amount of debt service which must be repaid annually to the lender.
g. Subtract the debt service from the net income to determine the cash flow (before taxes) remaining for the equity investors.
h. Subtract the loan amount from the actual project costs to arrive at the actual equity which must be invested.
I. Determine your cash return on equity invested. It should be close to 20 percent; if not, the project cost is too high, the rents aren't high enough, or something else is wrong.

There is nothing magical about the basic method of analysis and any competent mortgage banker will explain it. Caveat: the architect should use this type of analysis only to make sure the project is not way out of line (ballpark economics); his mortgage banker must prepare the final appraisal. One final word: remember that if a project's value is $3 million and it justifies a $2 million loan, the fact that it costs you $2.05 million means that your equity must be $50,000. If the actual project cost is $2.5 million, your mortgage will be the same (assuming the value is still $3 million), so you must then invest $500,000 instead of $50,000. And this equity must be invested before any mortgage funds can be drawn during construction. In short, the amount of the mortgage does not depend on the cost of the project.

5. Don't give up equity until necessary

Many neophyte developers think they must tie all the loose ends together before going ahead. Land development doesn't work that way. Equity investors tend to demand a larger percentage of the action the earlier they come into the deal. The risks are greater then. A better practice is to draw in investing partners only when necessary to fund the development, using your own credit prior to that time.

Here's one example: assume you have four investors putting up $100,000 each for the seed money to fund a project. That's 25 percent interest each for the actual cash invested to date. But if another $600,000 is needed, each $100,000 is a 10 percent interest. Or is it? If the original investors take the risk of getting the mortgage commitment, option, surveys, zoning change and other costs, the risk of later admitted partners is reduced, as should be their share of the equity. If they give a 40 percent interest for the last $600,000, the original four investors will each have an interest of about 15 percent rather than 10 percent.

6. Know basic financing techniques

Architects have a responsibility to design a project within various constraints, including available financing. Most architects are familiar with the permanent first mortgage and construction loan. Here are a few other techniques.
a. Standby commitments. A form of short-term temporary financing. Some real estate investment trusts will issue a standby for an amount slightly less than a permanent commitment loan. Two advantages are (1) although neither borrower nor lender expects to actually close the commitment, it is a bankable commitment against which a construction loan will be made, and (2) unlike a permanent loan, the developer is not locked into the loan for a 10-year period, which is common today. The standby lender will usually advance the interim construction funds.

The lender issuing a standby commitment always expects the developer to get a permanent loan once the project is up and leased. Later, a permanent lender is inclined to more favorably appraise a project actually leased, since rents and income are no longer speculative.
b. Gap financing. Permanent lenders usually condition their loans on the achievement of 80 percent of the projected rents. The borrower must obtain "gap" commitment from a lender who will agree to extend a commitment for the remaining 20 percent.

Then the construction lender will lend an amount equal to the full permanent loan.

c. Sale leasebacks. Frequently a developer can pull his equity investment out once the project is completed by selling off all or part of the project to an institutional investor and leasing it back. The land alone, the energy system or the entire project can be sold to any one of many investors looking for sound projects to purchase. (Such a sale can be prearranged conditional upon achieving specific rent levels.) Of course, rental payments will diminish future income to the developer, but the sale and leaseback will usually result in a substantial current profit for him, as well as the return of his capital.

Other techniques the architect should be aware of are installment sales contracts, wrap-around mortgages, bond financing, secondary mortgages, land development loans and government guarantees.

7. Understand the real costs of borrowing

If you don't believe that the effective interest rate on interim construction money is 12 to 15 percent, and you refuse to pay it, stay out of the land development game. A borrower at the so-called prime rate (and most are not) is not paying 8.5 percent. He's actually paying much more, because he must leave a compensating balance in the bank. Thus, on a million dollar loan with a typical 20 percent compensating balance of $200,000, the *effective* prime rate is 10-5/8 percent.

Real estate investment trusts have become a major source of short-term construction funds. Their money, however, is not obtained from small depositors at minimum rates as with commercial banks; their rates of interest must be higher to achieve a reasonable rate of return on their capital.

Permanent lenders also tend to use a variety of techniques to achieve the *effective* interest rate they are seeking. "Discounting" a loan creates the same effect as using a compensating balance. A lender will charge 9.5 percent interest on a million dollars, but discount the loan 3 percent and lend only $970,000. Or the lender will ask for a "kicker" (such as a percent of the gross income) which will provide him with additional return. In either case, the effective interest rate is always much higher than the stated rate.

8. Don't procrastinate . . . don't!

No architect in his right mind will advise a client to wait for construction costs to come down. Why

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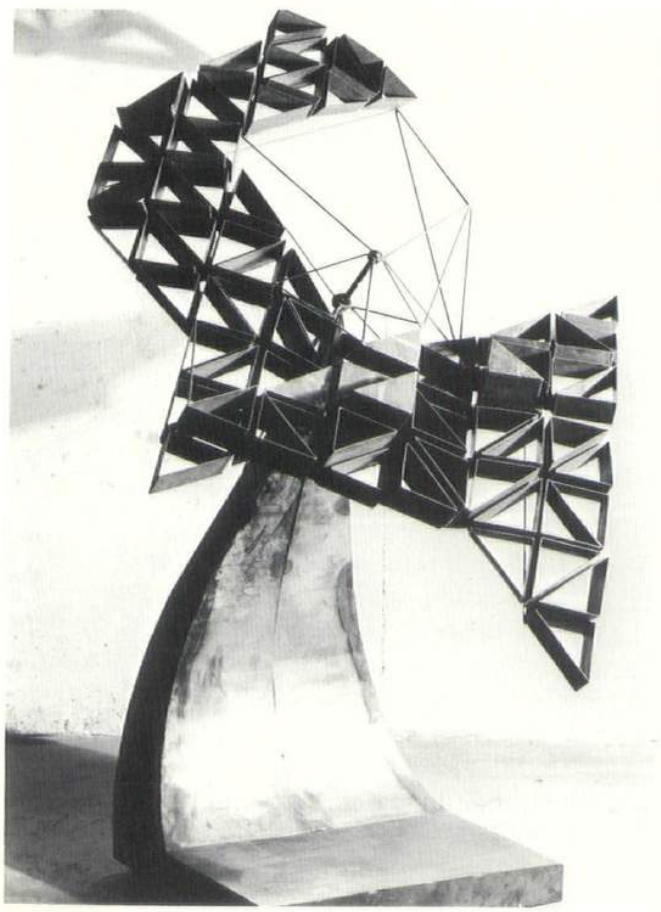

Theme sculpture "A Piece of the Action" by Julian Ominski

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wait if the project is a good one? Construction costs will go up ½ percent per month. Every month's delay is a permanent loss of almost 10 percent of a year's income from the project. In addition, property taxes and other carrying charges must be paid regularly on unproductive property. Faced with these hard facts, a developer with confidence in his project cannot afford to wait.

Forecasting future interest rates is a game for metaphysicians and fools with ouija boards. Moreover, any advantage achieved by slightly more favorable interest rates six months from now (assuming you take the gamble and guess correctly, which is unlikely) will be more than offset by inflation. In fact, it can be shown that a one-month delay can be justified only if the developer is absolutely certain that interest rates will drop a *minimum* of 1 percent.

Many developers who are delaying because of high interest rates are actually restrained because higher interest rates result in higher "cap rates." And higher cap rates have meant lower project values for projects (rule 4) and, therefore, smaller loans. As a result, it is now exceedingly more difficult to "mortgage out" (get a loan which will cover all project costs). Today, a developer must put his own cash into a project or raise it from equity investors. Many cannot effectively do this. Those who have the cash, however, are enjoying a field day in the burgeoning market demand for new housing and other construction. Those marginal developers who don't have the cash resources are idle.

9. Recognize lenders as unique personalities

Any developer in the country can walk into any lender and start negotiating for a loan. Out of the hundreds of lenders, however, the odds are high that he'll pick the wrong lenders for his project. Lenders don't like to say no directly, so they'll quote stiff terms and let you make the decision while delaying your move on to the next lender. Or they may simply ask you to wait awhile or make some revisions.

A developer may shop around for bids on his construction, but he's likely to draw a blank if he attempts to send his project simultaneously to several lenders. They won't waste their time once they find out that a developer is shopping his loan, which is a sure way to kill his efforts to get a loan.

The market for mortgage loans is difficult to grasp, due to the large number of lending sources, their many idiosyncracies and the fluctuating nature of mortgage terms. Most professional developers involved in large scale building will work with other professionals in mortgage banking in order to locate the lender and negotiate the best possible terms available for a specific purpose.

10. Select a competent mortgage banker early

The success of any project depends on three main factors: location, market and financing. Today, financing is frequently the deciding factor on whether a project goes ahead. The failure to consult a competent mortgage banker may result, as it often does, in the architect preparing a handsome (and expensive) set of drawings for a client only to later find that the project is not mortgageable for any number of reasons. Usually, a mortgage banker is willing to appraise the project's economics based on a preliminary program and concept, and then work with the developer to produce a project mortgageable in today's market.

A competent mortgage banker should also be able to develop an appraisal quickly (rule 4), and then advise on potential methods of financing. Moreover, he should be able to act quickly once the developer has decided to secure mortgage funds. Within 45 days after he's given the green light, the commitment should have been issued. The mortgage banker who lacks confidence in himself won't insist on a 45-day exclusive because he knows it will probably take him longer to produce (and such delays are costly for the developer).

Smaller mortgage bankers are often no more effective than the developer in placing the loan. They may adequately appraise the project's value, but because of their low volume of business, they will have weak contacts with the major lenders. Moreover, some smaller mortgage bankers are "correspondents" for one or more lenders. They get part of a fee from the lender and, more importantly, usually cannot take a loan to another lender (even though another lender might be the more likely to want it) until the correspondent's lender has refused it. Delays of six months and more are not uncommon when dealing with the wrong mortgage banker.

On the other hand, a competent mortgage banker will normally place a commitment within 45 days. He can intelligently select which lenders are most likely to be looking for this project currently and negotiate favorable terms. In brief, his knowledge of financing techniques, his contacts with lenders and his ability to negotiate quickly will avoid delay. ■

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March 22, 1972

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