



The Newsletter for Profit-minded Builders and Contractors

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Back to Basics: Look for Land

by Al Trellis and Paul Sharp

In many markets across the country, finding good land for residential construction at reasonable prices has become very difficult. The scarcity of land, competition from other builders, escalating prices, increased regulation, and longer approval times mean more hassles for the builder and higher prices for the consumer.

This is particularly difficult for the smaller builder, who lacks the financial resources to tie up large parcels of land for long periods, and who finds himself cut out of many new developments because he doesn't have the sales volume to interest the land developer. The builder facing this situation has several alternatives. He can continue to search for isolated in-fill lots at higher and higher prices, he can find better sources of land, or he can continue to build exclusively on other people's land, limiting his opportunities and profits.

Why develop land?

Developing land can be very profitable. At any given time in your market there is a limited supply of good lots, and being your own developer allows you to create the type of lots you need, at a pace you can handle and usually at a

Controlling land gives you an edge over those who build on other's land. If buyers want the land, they have to build with you.

better price than buying lots from a developer. If done right, you now have two profit centers – building houses, and developing lots.

Developing land is *not* for every builder. In fact, some of the largest building companies (such as *NV Homes*) do not develop their own lots. Developing land requires a huge time concentration, which can distract you from your major commitment of building houses. It also requires dealing with local government, with its bureaucracy, regulation, and red tape.

How much land do you need?

As a general rule of thumb, a

builder who builds on his own lots should try to control a two to two and a half-year supply. If you build ten houses a year, that means that you need to know where your next 20-25 homes are going to be built. In a period of escalating prices, the earlier you buy land, the less it costs, and the more profit you make on the land itself.

Some custom builders try to avoid this problem by building only on land owned by the homebuyer. While this minimizes the number of lots you need, it introduces other problems. When the builder owns the land upon which the house is built, he has much better financial control. If the buyer turns out to be totally impossible, the builder has the possible recourse of canceling the contract and selling the home to someone else. When the buyers own the land, they can choose anyone they want as a builder, asking for multiple bids, and reducing builder profit. When the builder owns the land, buyers have only one choice if they want to live on that particular lot.

Places to look for land

To find land you have to know where to look. Much of the land available isn't sprouting "For Sale" signs, and some of it is never on the market at all. Here are some places to look as you begin your search.



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Land developers. Because of the long lead times, initial purchase price, and high development costs, developing land can be quite risky. One way developers mitigate that risk is by committing land to a limited number of builders, who each agree to take down a certain number of lots. Unless you happen to be one of those builders, you may be excluded from building in that community. Even if you don't build in their communities, however, land developers are good people to know – because they may know of opportunities that were too small for their own operations but might be perfect for you. You can offer to pay them a finder's fee for referring these parcels to you.

Real Estate specialists. Certain real estate agents specialize in land sales. They know what's available, and if they do their job right, even know what land is *going* to be available in the future. If they know that you'll be looking for land in the future, they'll keep an eye open for you.

Land owners. Knowing who actually owns the land that you might want to build on in the future requires a great deal of time and energy. However, it never hurts to know who owns land adjacent to existing projects, and to maintain cordial relationships with them.

Other builders. Sometimes a builder may have more lots than he can effectively deal with. He may have had too aggressive of a take down schedule, or he may have undergone a financial reversal. Sometimes, he's simply anxious to begin work on a new development, and is willing to sell the final lots in his old development at a reasonable price. Other builders are also good to know in order to form alliances to take down projects together that are too large to handle individually.

Bypassed parcels. Sometimes lots are left undeveloped due to technical or design constraints. These lots are often in established communities with increasing property values. The parcel may be irregularly shaped, or have too much slope for the builders existing designs. By coming in with a new design, you may be able to use the lot, and turn a negative into a positive.

How much should you pay?

The price you pay should always be determined by these factors:

- **Market value of finished lots** – based on what comparable lots are selling for in similar neighborhoods.
- **Need** – How many lots of this size and price can the market absorb?
- **Yield** – How many lots can we get out of this piece of ground?
- **Timing** – How long will it take us to get these lots to market – including approval, infrastructure, and marketing?
- **Terms** – How does the seller expect payment? Possible options include: seller holds the financing, seller is willing to subordinate to a development loan, a fixed price (the cost of the lots is determined in advance), or variable price (the cost of the land is a percentage of the final sales cost of the house.)

Controlling land without developing

If you decide you don't want to be your own developer, you have to find ways of controlling lots developed by others. You don't have to actually own the land, in order to control it. As long as you have a contract with a land developer to supply you lots in the future, at a predetermined price, you control the land.

Buy the land. This is the least desirable option since it ties up your money, and places all the risk on you. Unless you have excess cash that's looking for a place to hide, it's better to spread the risk.

Takedown. This is basically an option to buy land at a predetermined schedule. The advantage is that you pay for the land as you use it, rather than all at once. The trick is getting the schedule right. If the schedule is too fast, you may be stuck with land you can't use, tying up your money. The best schedule is one that is a little slower than your anticipated needs, but allows you to accelerate the takedown at your option.

Rolling options. A rolling option simply requires a deposit on the next lot, as soon as you take down a lot. As long as you take down the next lot on schedule, the deposit is deducted from the purchase price. It allows you to control the land without an outright purchase of the land. The disadvantage of the rolling option is that if you miss your takedown schedule,

you could lose not only your deposit, but are out of the deal for future lots as well.

Series of contracts. In this arrangement, you write up a series of contracts for individual lots, each with a future settlement date. If circumstances force you to decline a lot, you simply forfeit the deposit on that lot, but it doesn't endanger your use of the other contracts. Varying deposits and price arrangements are often the key to a seller accepting this arrangement.

Partners. Another way of spreading the risk and developing product synergy is to partner a development with three or four other builders. These should be complementary builders, with similar concerns for aesthetics and quality. You may decide to build for different market segments within the same development, with each builder taking a different segment. The advantage is that you have greater resources for marketing and development, can build out a development faster, and have less individual carrying costs.

Myths about buying land

There's not enough land to go around

Mark Twain once advised a relative "Buy land. They don't make it anymore." This is true, but there is still plenty of land to go around. Compared to much of the world, the United States has a low-density population, with approximately 79 people per square mile. That's one person for every 8 acres. The Netherlands has 16 times as many people per square mile. And yet, when you drive through the Netherlands, you see lots of beautiful countryside, with farms and fields of flowers. While there's lots of available land in the U.S., much of it isn't in the places where people want to live. In areas where people do want to live – San Diego and San Francisco, for example, land is in short supply and is expensive. Land that is further from population and employment centers is less expensive, but entails greater transportation costs.

All the best land is taken

This is related to the first myth, and to a degree this is self-fulfilling. Of course people always build first on the best land that is available. Why would they want to build on the worst land? But worrying that the best land is taken is like lamenting the

fact that you didn't buy Microsoft stock when it first went public. You simply look for the best land that is still available.

Then you develop it in such a way that you make it more desirable – adding public spaces, parks, amenities, and curb appeal. If the best land isn't available, take the second best – and make it better.

The bigger the lot the better

While some people dream about living on a large country estate, not too many people are willing to pay what it would take to obtain the land and maintain it. Many people, especially as they get older, want less land to take care of, with less lawn to mow. They prefer houses in closer proximity, with closer neighbors, and shorter walking distances. They may not want apartment or condominium densities, but one-quarter acre is fine, rather than the two-acre estate they lived on previously. They want small town densities, rather than suburban sprawl.

Land prices can only go up

While the trend over the recent past has been ever increasing land prices and home prices, this very increase could contribute to a softening of the market. In many cities, we are already at the point where the median family income cannot afford the median priced house. When too many people are priced out of the market, demand inevitably falls, and prices stagnate or decline. Increasing home prices also contribute to inflation, which could lead to higher interest rates, pushing the cost of home ownership even higher. All it would take is one major economic shock to create a panic. As long as demand for housing remains high, however, prices and demand for land will continue to rise.

The more expensive the land, the more money you can make on the house

To the degree that the price of the land reflects on value and desirability of the location, this is true. Waterfront property and golf course views add to the cost and perceived value of the house. However, some land is overpriced, and there is a limit to what some people will pay. The price you get for a home is determined by the market – not by your costs. If you

overpay for the land, it will simply decrease the money you can make.

You have to know the right people to find land

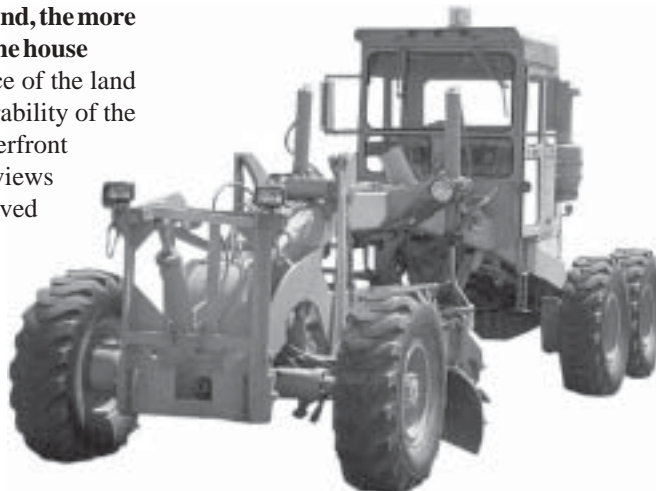
Well, it never hurts to know the right people, but if you don't know them, all you have to do is pick up a phone and call them. Developers, real estate agents, and even landowners are always interested in talking to potential buyers. If they don't have anything you're interested in right now, don't hesitate to ask them to keep their eyes and ears open for future deals.

It's just too much of a hassle

Obtaining land is rarely a hassle if the land is pre-approved. The hassles come about when zoning changes are requested or a major development is introduced into an established neighborhood. The NIMBY mentality (Not In My Back Yard) is often inconsistent and hypocritical, but it is based on a fear of declining property values. Show them how the proposed development will increase the value of their community, and they might come around. If you're just offering more sprawl and a design that's inappropriate to the neighborhood, don't expect them to welcome you with open arms.

I don't have the money to develop land

That's what banks are for. As long as you're financially stable with a good track record of profits, you should have no problem finding banks willing to loan up to 50% of the purchase price, and 90-100% of the development costs. A project proforma and appraisal will be needed to support an acceptable loan to value ratio of approximately 70%. If the project is too big for you to handle alone, partner with some other like-minded builders to share the costs.



Harvard Insights

One of the best sources for management ideas is the *Harvard Business Review*. When we run across an idea of particular interest we will try to summarize it for you and tell you how it applies. For a full copy of the article, go to your library, subscribe, or purchase a reprint.

When Good Customers are Bad

In the September 2005 issue of the *Harvard Business Review*, Remko Van Hoek and David Evans raised a point of interest to custom and semi-custom home builders. They assert that “companies don't just sell product; they sell “delivered product.” The delivered product includes a whole range of services, including delivery, special handling etc. And most companies have no idea how much the total cost of that delivered product may be.

For home builders, those extended product services include plan customization, design advice, product selection, and all the hand-holding and customer service that typically are associated with building a new home. While builders usually have a good grasp of the “hard” costs of building, including materials, labor, and subcontracting, the “soft” costs can vary radically from customer to customer, making some of those otherwise profitable customers less so.

Some companies are now using “cost-to-serve” analysis to track these costs and determine whether or not a major customer can be served profitably. This analysis can be used to reduce delivery costs, and determine which services will, and will not, be offered. While an unwillingness to “jump through hoops” may result in the loss of an occasional client, this is preferable to losing profit on the client in the long run, and losing the opportunity to service other customers more profitably.

Ask AI by AI Trellis

Calculating square footages

Q: What is the standard way of computing the square foot cost, and how should it be used in marketing custom homes?

A: Start by defining the standard custom house in your market. If a full basement is typical, it must be factored into the calculations. The same things applies for such items as two- or three-car garages, heavy landscaping packages, upgrade appliances, floor finishes, marble foyers, and master baths.

Next calculate the square footage of *finished* floor space. This does not include garage, decks or patios. Two-story space is only counted on one level. Basement and attic space is not included even if it is finished. The cost of finishing these areas should be quoted as optional extras.

Finally, determine the total cost for the home including the typical features of houses in your area. Do not include lot cost and "soft costs" such as marketing and financing.

The cost per square foot is the total cost divided by the finished floor area. Now that we have the cost per square foot, what do we do with it? One thing *not* to do is to use it as a substitute for detailed cost estimates. Each custom home is unique and must be treated as such.

When a potential client comes to you without plans and specifications, having a per square foot cost or cost range can help you learn if the project is in the right ball park. If your range is \$180-200 per sq. ft., and they have a budget of \$600,000, you can tell them that a home with 3,000 to 3,300 sq. ft. of finished floor space is achievable. This approach also opens the way to offering the client a variety of floor plans and elevations to fit the size range determined.

A Pattern Language by Paul Sharp Positive Outdoor Space

Christopher Alexander wrote *A Pattern Language*, outlining over 250 rules of thumb (patterns) that affect home design. We've highlighted some of our favorites. Pattern No. 106 *Positive Outdoor Space* deals with the way spaces *between* structures can improve livability.

"Outdoor spaces which are merely 'left over' between buildings will, in general, not be used. Therefore: Make all the outdoor spaces which surround and lie between your buildings positive. Give each one some degree of enclosure: surround each space with wings of buildings, trees, hedges, fences ... until it becomes an entity with a positive quality."

The use of outbuildings such as storage sheds, detached garages, fences, half walls and outdoor spaces (gazebos, pergolas, etc.) can do a lot toward making indoor/outdoor living more enjoyable. Most builders, however, treat these as an afterthought, and miss an opportunity to add a great deal of perceived value at little additional cost. Pay attention to the size and proportion of those spaces, in order to make them usable and comfortable.



The rear loaded garage and connecting wing define the outdoor patio space and give it a sense of enclosure. Floor plan by David Court.

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Quote of the Month

"Half our life is spent trying to find something to do with the time we have rushed through life trying to save."

– Will Rogers

Next Month: Back to Basics: Maintain an Inventory. Building a few spec homes can increase your profits, smooth your work flow and make your life a little easier.