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Golden Hills

Residential Development

by: Lars Kollmann & Brad Olson

Case Study Number: A001-June-2009

Golden Hills

Residential Development

This case study incorporates the following real-estate themes and issues:

Residential Development

Land Use Planning

Master-planned Communities

Financial Analysis

Market Analysis

Feasibility Analysis

ABSTRACT

The Golden Hills Case Study is focused around the financial analysis and evaluation of two undeveloped tracts within a master-planned community in the Los Angeles region. The owner of the two parcels, Reality Development, has received an offer from a competitor to buy the land. In the role of Marc Baker, the protagonist of the case study, the task is to evaluate the net present value of the land if Reality were to develop it and compare the results again the offered price. As the market had turned after the burst of the internet bubble and demand for smaller unit had increased, the approved plans and product mix - that would represent a continuation of the existing surrounding - appeared to be not the most favorable solution as it has a concentration of three-bedroom houses. For this reason an alternative product mix with increased density and a faster overall absorption was developed. But not only the start of the construction would be delayed as the new design would maybe also face resistance from the existing community. A decision is to be made on how to proceed, assessing both the quantitative as well as relevant qualitative aspects.

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This Cornell University Real Estate Case was prepared by research assistant Lars Kollmann under the supervision of Senior Lecturer C. Bradley Olson to stimulate analysis and discussion in undergraduate and graduate real estate courses. While the case is drawn from actual circumstances, it is not intended to illustrate correct or incorrect applications.

Case Study in Residential Development: Golden Hills

by Lars Kollmann & Brad Olson

Author

Lars Kollmann, a 2009 Cornell PRE graduate, was born near Frankfurt, Germany and graduated from the Technical University of Darmstadt in 2004 with a diploma in architecture. After graduation he worked as a self-employed architect and completed several residential projects in the Frankfurt region. Lars then moved to China and served as an architect and project manager for the Munich based company Obermeyer Engineering and Consulting in 2005. Lars participated in the project management for the new Airbus A-380 Hangar at Beijing Capital Airport. Subsequently, he became the project and site manager for the construction of a 150,000 square feet rubber refinery plant in the city of Wuxi, China where he was responsible for coordinating the full project team. Subsequently he compiled the RFP-documents and conducted the bidding process for the extension of the German Embassy School in Beijing in spring 2007. In the summer 2008, Lars joined Hines in Germany for an internship, working on the refurbishment of a 300,000 square feet commercial project in the city of Stuttgart.

"Sorry to keep you waiting", said Anthony Jackson, Senior Development Director with Reality Development, as he entered Marc's office. "I had John Covington run a few calculations based on your assumptions and we determined that, on a quarterly basis, general and administrative expense (G&A) for the first option will be $210,000 and $235,000 for the second option. You can use these figures." He handed Marc a list with a more detailed breakdown. "Thank you Anthony, this is what I've been waiting for," said Marc. "Is there anything else you need, Marc?" Anthony inquired. "Thanks, Anthony--I think I have all the information I need to proceed. Kevin Burke gave me an estimate of the construction and infrastructure costs," said Marc. Anthony replied, "I saw the email but have not had a chance to review it yet. Good job Marc. I'm looking forward to receiving your final report. I am planning to make a recommendation to the Board of Directors at their meeting next Thursday"

Background

Marc had joined Reality Development's Los Angeles office two months ago, moving from Chicago. His wife, Ann, had been offered a partnership position in LA with Kapper, Ruf & Smith, one of the nation's leading intellectual property law firms. His own career had never really taken off and they decided to accept Ann's offer and to move to Los Angeles.

While uncomfortable with his wife out-earning him, Marc had lived with this fact since their marriage in 1995. He previously worked for a successful Chicago-based residential developer as an assistant project manager. However, his advancement at that firm was stymied by a series of missteps. There were missed deadlines, disagreements with a project manager over general contractor negotiations, and budgeting and scheduling errors.

Many of Marc's mistakes resulted from youthful inexperience but they had hurt his career advancement at the Chicago firm. He watched as many peers got promoted to Project Manager and beyond while he languished in the same assistant project manager's role. Marc was looking for a new start, unencumbered by mistakes of the past and offering the opportunity to prove that could successfully execute a project.

Reality Development (Reality) was a nationwide development company, primarily active in the office and mixed-use sectors. In an attempt to grow the company, Lewis Haynes, the company's founder and owner, decided to build up the company's residential expertise. As a part of this effort, Reality had purchased GTKF, a midsized development company that was active solely in the Los Angeles basin. After a series of fraud investigations in early 1999, GTKF had struggled. These incidents, in addition to several poorly received projects, forced GTKF's former owners to sell their shares. Reality saw this distressed situation as a prime opportunity to buy cheap and capitalize on the growth in the region. Reality was especially interested in GTKF's underutilized prime sites in attractive urban and suburban locations. In September 1999, one month after the acquisition, Reality decided to focus on these top sites. During the takeover, many former employees of GTKF were either laid-off or left the company. This employee turnover resulted in some confusion as Reality attempted to integrate its own staff into former GTKF projects. In addition, during the earlier fraud investigation, many files had been removed or couldn't be found.

Within several months, the development process for the prime sites was under control, but that process was tying up most of Reality's personnel. Reality started recruiting staff for their Los Angeles office to begin developing the remaining somewhat less attractive sites acquired from GTKF. Among these new employees was Marc Baker. He was given the opportunity to work as a Project Manager for residential development projects. Marc considered this his "last best chance" to restart his career.

In January 2000, while he was interviewing with Reality in their Los Angeles office, Marc learned that he would be hired to work on one of the smaller suburban fringe sites obtained from GTKF, which contained 21 acres of buildable land. The project was called Golden Hills, a residential development project, located in the edge City of Saint Denis, about 60 miles southeast of Los Angeles.

Marc was told that his initial responsibility would consist of analyzing and evaluating this project. Further, if Reality decided to proceed with the project, he would likely be the project manager. From these initial conversations it became clear that his future with the company was dependent upon his ability to successfully evaluate and execute this project. Marc realized that this was an excellent opportunity to redirect his career path. Given his recent challenges, he felt enormous pressure to succeed. In early February he accepted the offer and he and his wife relocated to Los Angeles.

Marc's Start with Reality Development

In early April, Marc started work as a Project Manager with Reality, reporting to Anthony Jackson, a Senior Development Director in his late fifties. Marc had met Anthony during the application and interview process. They got along well and it appeared likely that Anthony had advocated hiring Marc.

During their first meeting, Anthony introduced the Golden Hills site. Marc learned that the site was part of a large master planned community acquired by GTKF in 1993. The property had originally been developed by a California-based land developer, the Evans Company. GTKF had purchased a total of 76 acres of land consisting of five tracts. Three of these five tracts had been built-out and sold to by GTKF. As the company started to struggle in 1998, Golden Hills was one of the first projects put on hold. The City of St Denis had approved the final construction drawings just prior to that decision. The final two tracts, D and E, comprised approximately 21 acres, ready to be built-out.

During their conversation, it became obvious that Reality Development was uncertain about what to do with the land. Anthony was anxious to find a solution, because carrying costs were a significant cash flow burden. In addition to interest expenses, the annual real estate taxes amounted to $230,000. Based on the purchase agreement with GTKF, Reality Development was also required to pay $58,000 per quarter in dues to the Golden Hills home owners' association. This money was spent to maintain community amenities and infrastructure that the Evans Company had previously put in place. These payments were linked to the ownership of the land and would decrease, on a prorated basis, as the land was sold. The residents of Golden Hills were pressuring Reality to build out the remaining land. They wanted to see the neighborhood completed.

According to Anthony, GTKF paid $41,600,000 for the 76-acre site in 1990. In 1995, GTKF was required to pay an additional $2,300,000 for its share of the club house facilities. Before Reality acquired GTKF, the remaining tracts, D and E, had a combined (GTKF) book value of $11,500,000.

In 1999, Reality acquired GTKF for $367 million in cash and assumed debt. The acquisition included fourteen properties in the Los Angeles region, with a variety of residential, retail, and mixed use projects in various states of completion. Reality assigned Anthony the task of determining Golden Hills' fair market value. To do so, Anthony had called Peter Adams, co-founder and owner of Adams & Wilkinson, the leading residential

Author

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brokerage firm in the metropolitan Los Angeles area. After years of working with Reality Development, Peter was in good standing with the firm and had a close personal relationship with Anthony. Peter gave Anthony his opinion as to Golden Hills' value. Based on this opinion, Reality allocated an acquisition book value of $9 million to the Golden Hills sites D and E.

In the middle of January 2000, Reality was approached by Howard & Richardson (H&R), a regional homebuilder. Their initial offer for tracts D and E was $6,200,000. Towards the end of March, shortly before Marc began employment with Reality, H & R increased their offer to $6,975,000 cash.

Introducing these figures to Marc, Anthony exclaimed, "I hope this is not the true value of the land." Anthony had depended upon Peter Adams' value estimate for Golden Hills and risked his reputation within the company if he subsequently admitted to the potential mispricing, especially given the limited due diligence he had conducted.

Although these were now sunk costs and would not influence the value of future cash flows, Anthony was concerned that subsequent devaluation would reflect poorly on him. "H & R has constructed several other tracts within the Golden Hills community and were closely monitoring our acquisition of GTKF. It seems like they are trying to capitalize on the current situation with the new ownership. On the other hand, our attempts to sell the land to other builders have been unsuccessful. This is why I need you to review the existing documents and prepare a report valuing the project. Assuming that Reality develops the land and builds out the units, I need you to run a net present value calculation assessing the site's residual land value.

I have learned from various brokers in the area that housing demand has been shifting towards smaller unit sizes. For this reason, the current plans may not be the best solution. To generate alternative concepts, please feel free to contact Ashley Winter, one of our senior architects and site planners. She can help you out. Later today, you should visit the site and explore the area. John Covington, one of my assistants, grew up in the area and will show you around."

Golden Hills and Saint Denis

During the trip to Saint Denis, Marc learned a lot about the region. St. Denis, with a population of 87,500, is located southeast of Los Angeles in a region south of the San Bernardino Mountains. It was established in 1917. For many years, St. Denis remained primarily devoted to the cultivation of agriculture. However, as Los Angeles sprawled toward the East and then South St. Denis began its march toward development. In the 1970s, the City's mayor successfully lobbied the state for funds to help it develop a central business district to spur commerce and attract residents to the region. The City's lobbying efforts paid dividends, with the City's tax base growing fourfold and its population growing tenfold. However, to date, St. Denis remained a bedroom community, inhabited primarily by residents commuting long distances to jobs at sites closer to Los Angeles.

Mark had a positive experience exploring the Golden Hills community (Exhibit 1). The community had attractive open spaces and excellent amenities, including a large clubhouse and several outdoor pools. Tract D (Exhibit 2) was located adjacent to a community park. The general quality of the existing units appeared to be high. Mark started to understand why the community was pushing Reality to complete the project. Sitting between two entrance gates, tracts D and E had a prominent location within the Golden Hills community. However, weeds and trash covered portions of the land, detracting from the community's otherwise attractive appearance.

During his site visit, Mark noticed that the site's backbone infrastructure – including the intersections intended for future connections to the subdivision – were fully constructed, limiting the site's future layout. He could not find any obstacles preventing Reality from quickly building out the site.

Marc also had a chance to talk to some of the neighbors. It seemed that they genuinely liked the area and the community. After Marc revealed his identity, various neighbors asked why the community was still not completely built out. The vacant land was an eyesore. The mounds of disposed building materials also created potential hazards on which children and dogs occasionally played. The vacant land was viewed as a public nuisance that lowered surrounding property values.

Exhibit 1: Golden Hills and Vicinity Map

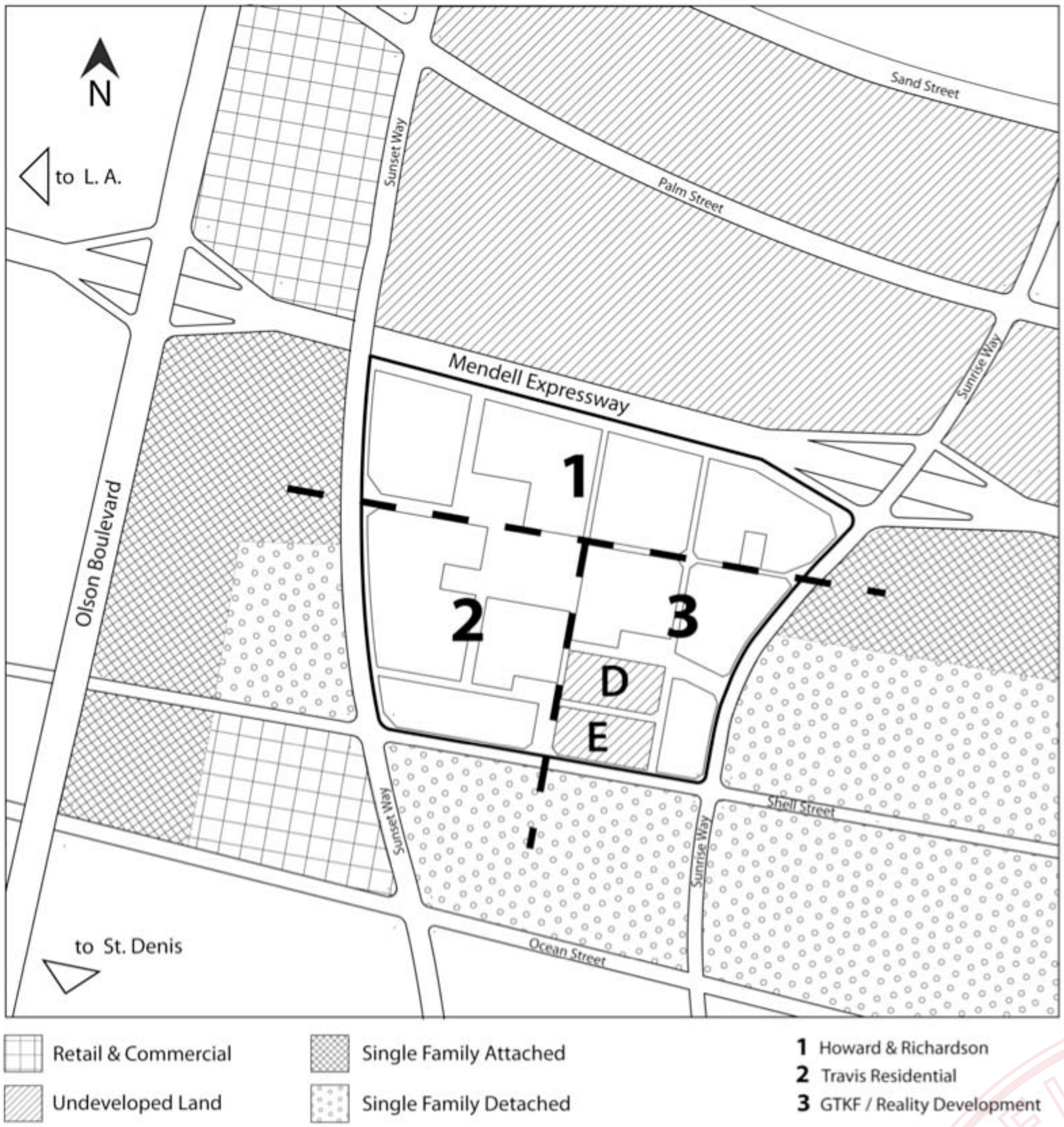
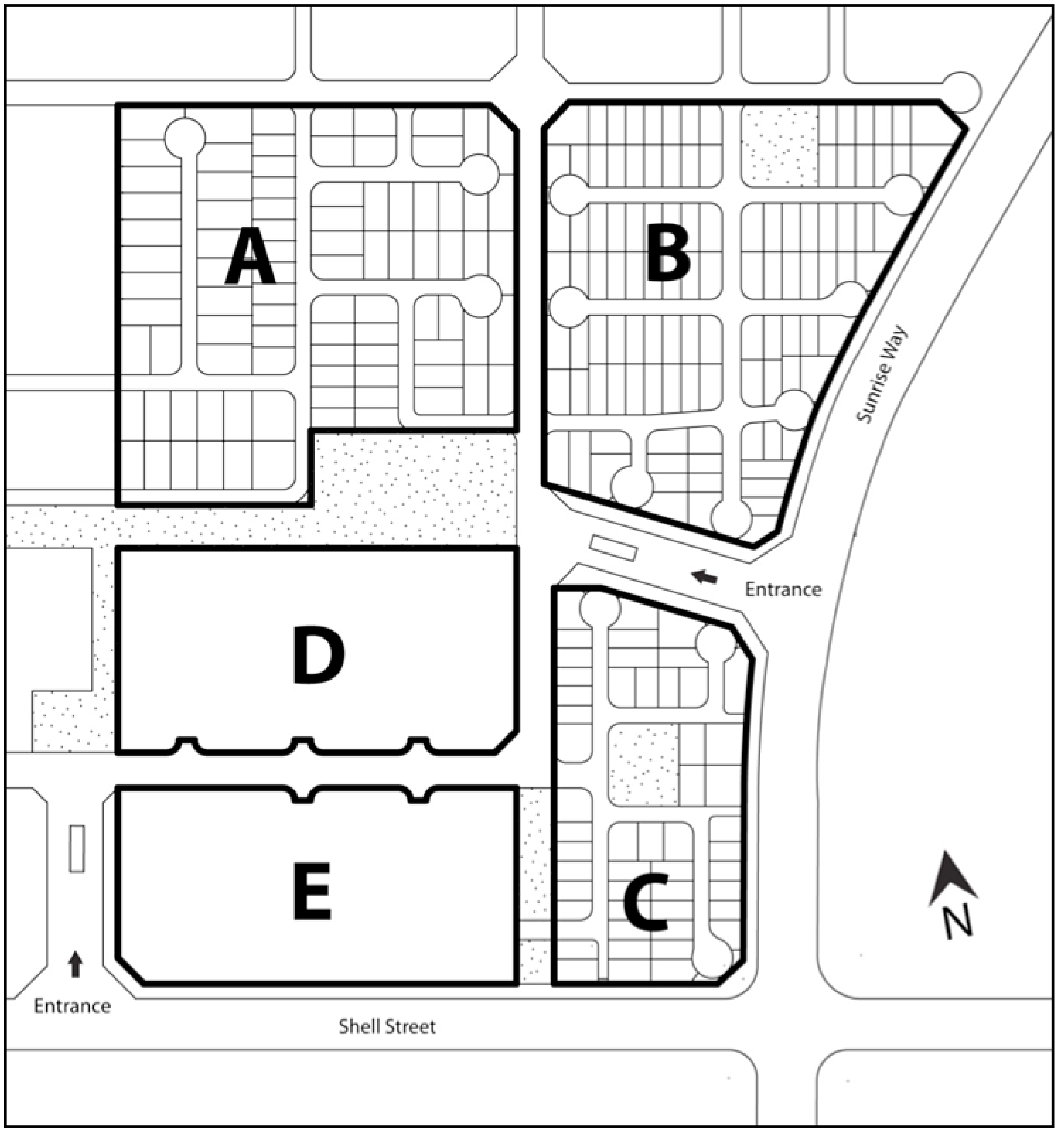


Exhibit 2: GTKF's original ownership in the Golden Hills community



Existing Product Mix for Tracts A to C

Tracts	A	B	C	A+B+C
single family detached				
two bed rooms	12	5	9	26
three bedrooms	76	103	41	220
Townhomes	0	0	0	0
Total	88	108	50	246

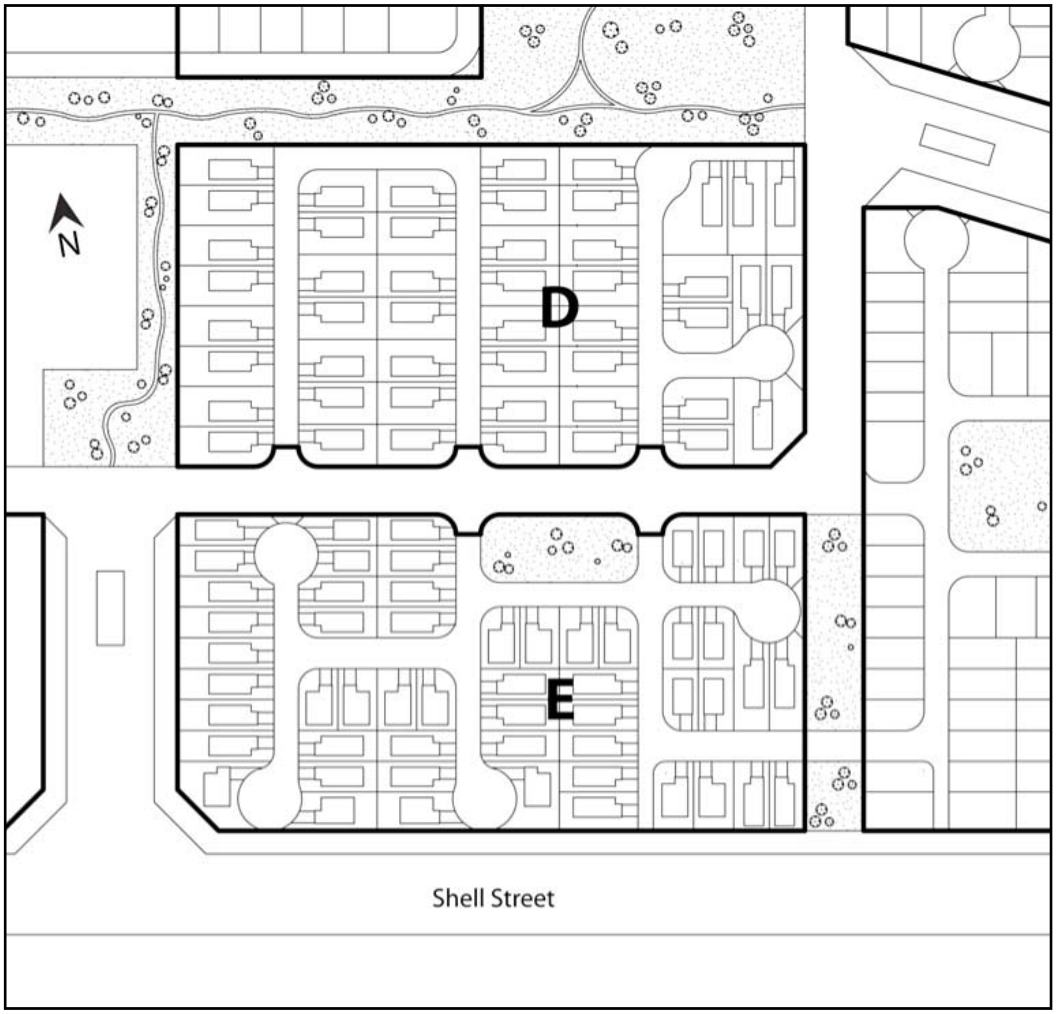
Option A

Reviewing the existing land and approval documents, it became clear that one possible solution included proceeding with the product mix and design as formerly envisioned by GTKF (Exhibit 3). The City of St. Denis had already approved all necessary zoning and construction documents for this option. Construction could start with minimal delay.

Essentially, this approach represented a continuation of existing tracts A to C. Those tracts included a high concentration of larger three-bedroom single family detached homes. An additional park was to be built on tract E. GTKF's original plans offered two different two bedroom models and three different three-bedroom models.

This option had a weakness: the likely absorption rate. Based on Marc's review of current market data, Anthony's initial concerns were well founded. Market demand in the area for bigger and more expensive homes had declined significantly. A substantial amount of comparable slowly selling inventory existed. In contrast, the available data and conversations with local brokers clearly showed a growing preference for smaller and more affordable houses, which were in limited supply.

Exhibit 3: Option A: GTKF plan as currently approved



Approved Product Mix for tracts D and E

Tracts	D	E	D+E
Single family detached			
(2 bedrooms)	0	10	10
(3 bedrooms)	48	44	92
Total	48	54	102

Option B

Marc's gut feeling told him that attached townhomes might be a suitable product type on the remaining sites D & E—allowing Reality to increase the density and to attract buyers that were looking for houses at a more affordable price point. Marc felt relatively confident about adding this product type, because he had successfully built and sold attached townhomes in past projects and felt he had the expertise to make this solution work.

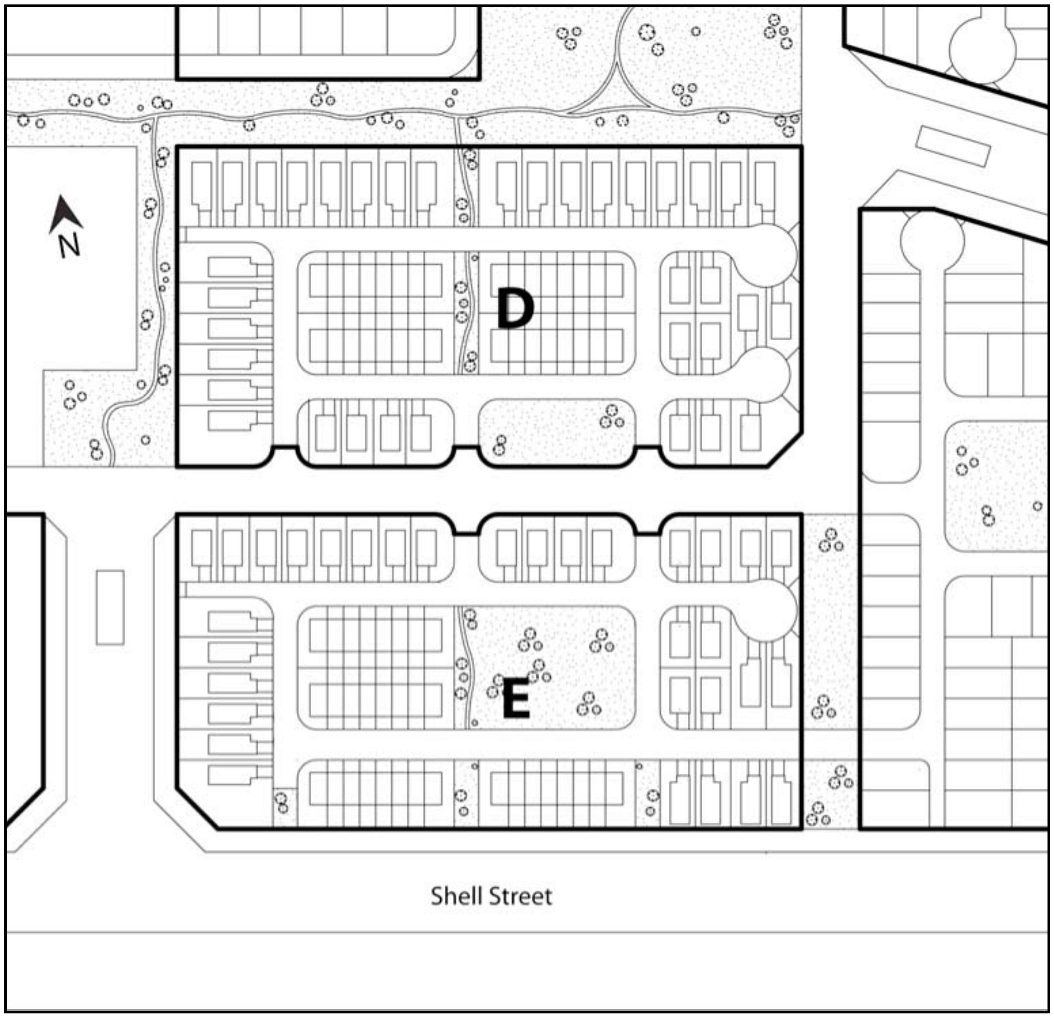
His next step was to talk to Ashley Winter. He told her that he was looking for ideas for redesigning the site to increase the number of smaller units and add townhomes. Within a couple of days, she presented a new design proposal (Exhibit 4). Marc liked her approach. She had added a total of 64 attached townhome units while reducing the number of three-bedroom detached units. All of the townhome units were centered within their respective tracts or placed along the internal edges of Golden Hills. The rationale behind that strategy was to maintain the current appearance within the community. Ashley's concept also increased the amount of open space and added walkways to improve connectivity to the community park.

Ashley told him that she had checked the zoning and other legal requirements for the site and concluded that attached townhomes and the related density were permitted. They decided that attached townhomes could be offered as three different models: a corner unit and two middle units that varied slightly in size. All of the townhomes would be three bedroom/2.5 bathroom units. Though comfortable with the product type, Marc was not sure whether townhomes would sell in the Golden Hills community of Southern California. He also was not fond of the increased park space. He showed the idea to his supervisor, who immediately liked it. However, Anthony was concerned that the attached townhomes – though not visible from the main streets within the community - might not be appreciated by the current residents of Golden Hills--especially as the increased density would likely increase the use of the common areas. Anthony advised Marc that this issue would require further investigation and could become a deal breaker for this option. Concessions to the current residents might well be required in order to resolve such objections.

Anthony introduced Marc to Peter Adams from Adams & Wilkinson, asking Peter to provide another opinion of value. Upon review, Mr. Adams also liked the proposal. He told Marc that selling the attached townhomes in the current market should not prove too challenging because there was a growing market for midsized homes at affordable price points. However, Peter was also uncertain how the existing community would view this option. He also gave Marc various examples of previous communities where this strategy succeeded. He provided other examples where community opposition was too strong to overcome and the developer had been forced to eliminate the attached townhomes.

Next, Marc showed his proposal to Kevin Burke, one of Reality's local government liaison managers. He told Marc that the creation and final approval of the new site improvement and building plans and documents should be possible, but would likely take approximately 15 months. The total related costs for this effort were estimated to be $825,000 and would be incurred evenly over that period. While rezoning of the site was unnecessary, the site plan would still need to be approved by various governmental authorities. In total, the review and or approval of at least 6 governmental authorities would be necessary.

Exhibit 4: Option B – Townhome Option as proposed by Ashley



Winter

Proposed Product Mix for tracts D and E

Tracts	D	E	D+E
Single family detached			
(2 bedrooms)	13	20	33
(3 bedrooms)	23	12	35
Townhomes	32	32	64
Total	68	64	132

Scheduling

Marc decided to use a quarterly schedule for this analysis. He was assuming that tract D would be completed first, because it was located adjacent to the community park. In addition, he assumed that the number of housing starts would be consistent with the number of units sold in the previous quarter and that they would be delivered upon completion of construction.

For Option A, Marc assumed that the project would start during the third quarter of 2000. This start date would be used for preparation and construction of the marketing center. In the last quarter of 2000, active marketing and the construction of the on-site improvements for Tract D would start. Housing construction would start in the first quarter of 2001 after access roads and major site work was completed. For Option B, Marc kept the same basic assumptions, but delayed the start of construction by the amount of time it would take to create and secure approval of new site work and building plans.

Selling and Marketing

To assess the related expenses, Marc met with Tim Myers, the head of Reality's marketing and sales division for the Los Angeles office. Tim said that the construction costs for the marketing center would amount to approximately $325,000 and that operating expenses would amount to $33,500 per quarter. Advertising costs would add $27,000 per quarter. Commission and closing costs were would be $6,120 and $4,610, per detached and attached unit sold respectively, based on the likely sales prices.

Comparables

In determining the proper inputs for the proforma, Peter Adams again proved to be invaluable. He helped Marc create a list of relevant comparable sales for the project. This was extremely helpful to Marc in understanding the local market. Marc also visited most of the sites in person and concluded that this revised plan for Golden Hills would be a competitive development.

Exhibit 5: Comparable communities, April 2000

	Community specifi c		Plan specifi c				
Community Name / unit type	Opening date	Units Sold (Total / to date / last quarter)	Plan Square Foot	Bed/Bath	Monthly HOA Fees	Current / historic base price	Value Rati o ($/sq.ft .)
Golden Hills, Tract C	1996	(50/50/-)					
SFD			1960	2/2	427	332,000	169.39
SFD			2730	3/3	487	418,200	153.19
Marine Club	Nov-97	295/143/17					
SFD, 407c			1795	2/2	498	368,000	205.01
SFD, 212			3298	3/3	525	588,000	178.29
Murano	Feb-98	162/82/16					
Duplex, 43b			1673	2/2.5	513	343,000	205.02
SFD, 128			2775	3/3	642	478,000	172.25
Townhome, Millenium			1960	3/2.5	567	357,000	182.14
Sunset Hills	Aug-97	68/64/9					
Townhome, 18b			2145	3/3	338	392,000	182.75
Oak Tree	Dec-97	113/92/14					
SFD, Malibu			1739	2/2	467	367,000	211.04
SFD, Marquis			2472	3/3	524	489,000	197.82

Revenue and absorption rates

Based on the table of comparables, Peter and Marc determined the price points and the related absorption rates for option B. They agreed that the option B townhomes would cannibalize sales of the two bedroom units and would slow sales of the three bedroom units, because the overall density increase would deter certain buyers. To estimate expected revenue from upgrade sales, Marc used Reality's experience with similar projects.

Exhibit 6: Weighted average sales prices and weighted average upgrades

	Revenues				Absorption Rates (quarterly)	
	Base sales price	Value Ratio	Upgrades		Option A	Option B
single family detached						
- two bed rooms (1,848 sq. ft.)	$ 383,200	$193.29	$ 14,900		8	4
- three bedrooms (2,506 sq. ft.)	$ 435,700	$173.86	$ 29,100		6	5
townhomes (2,166 sq. ft.)	$ 369,300	$158.96	$ 15,800			8

Financing assumptions

For the determination of the NPV, Reality's unleveraged hurdle rate was 12%. Reality's standard practice was to use 2.5% as the inflation rate for pro forma analyses. Due to the unpredictable nature of the current markets, Marc was advised by Anthony to inflate the costs only and assume that revenues would not increase.

The decision

After Marc had compiled this information, the time had come to evaluate the different options. He performed similar evaluations in his past job but on less complex projects. Even though it needed some adjustments he was planning to use Reality's proforma template (Exhibit 8).

He wondered whether he would really be permitted to lead the project if his evaluation indicated that Reality should build out the site rather than sell it, and what his future would be if the land was sold. On the other hand he was still not certain whether the market would support the alternative plan. There was also uncertainty about whether approvals could be obtained within the estimated 15 months.

He still had no firm understanding of the market and furthermore, he was not sure whether the current residents would accept the increase in density. To go ahead with Option B might require a substantial concession towards the existing communities such as the improvement of existing public spaces.

Generally, however, he had a very positive feeling about the community of Golden Hills and he also liked the sample floor plans and sketches that Ashley had created in order to illustrate the potential of the site (Exhibits 9 to 11). He strongly felt that Golden Hills option B had a competitive advantage.

Finally, he reflected on his conversations with Anthony during the hiring process and how his future with Reality Development seemed linked to his ability to meet Reality's expectations. He wondered whether there might be another exit strategy that has not been considered yet.

Exhibit 7: Email from Kevin Burke

From: Kevin Burke <Kevin.Burke@Reality-Dev.com>
To: Marc Baker <Marc.Baker@Reality-Dev.com>
Cc: Anthony Jackson <Anthony.Jackson@Reality-Dev.com>
Subject: Construction and Infrastructure Cost Estimate / Golden Hills
Date: Tue May 01 13:03:54 WST 2001
Attachments: 20080506_Golden Hills_Cost Estimate.xls

Marc,

Attached is a detailed breakdown of our estimate for the construction costs for the Golden Hill project, based on the assumptions that we discussed during our meeting on April 16th. I apologize that it took me awhile to compile the requested information. Prices are changing quickly right now and I wanted to be sure to give you with up-to-date information. Here is a summary of my findings:

Direct Construction Cost

	Weighted average size (sq. ft.)	weighted average direct construction cost (per sq. ft.)	Total
Single family detached			
(2 bedrooms)	1,848	$ 63.45	$ 117,256
(3 bedrooms)	2,506	$ 51.71	$ 129,585
Townhomes	2,166	$ 55.73	$ 120,711

Site work cost

	Option A		Option B	
	Tract D	Tract E	Tract D	Tract E
Utilities and Street Improvements (@$825/ l.f.)	$ 1,526,250	$ 1,749,000	$ 1,872,750	$ 1,901,625
Landscaping (lots)	$ 480,000	$ 620,000	$ 420,000	$ 570,000
Recreation and common area	N/A	$ 560,000	$ 320,000	$ 520,000
Total (site work cost)	**4,935,250**		**$ 5,604,375**	

You may assume it will take two quarters to construct the infrastructure and that costs will be evenly incurred during the quarters. The infrastructure for both tracts will be built at the same time. Construction of the housing units generally takes nine months. I have also researched the gross-margin of upgrades. For comparable projects, the historical figure amounts to approximately 47%.

I hope this information helps you, let me know if you have more questions.

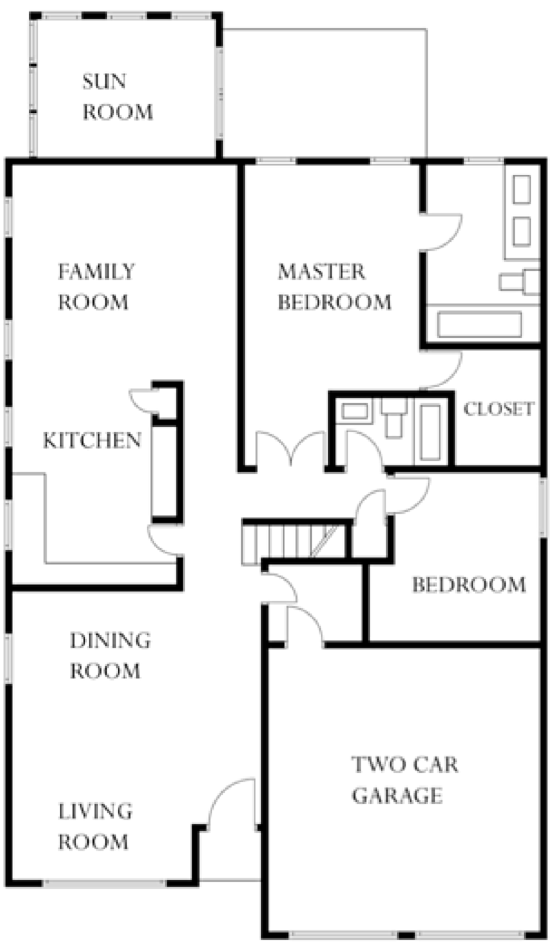
Best regards,
Kevin

Exhibit 8: Proforma Template

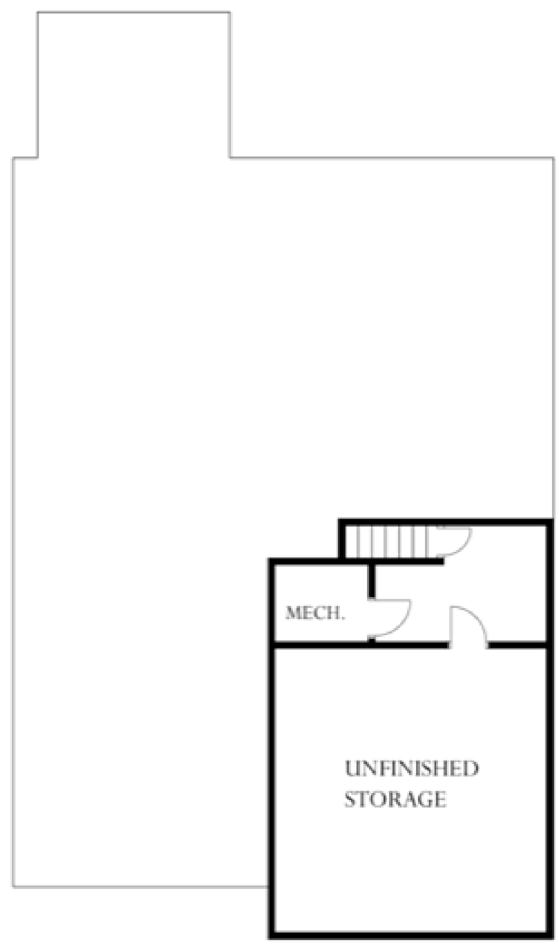
Company name:	Reality Development
Division name:	Los Angeles, CA
Location:	
Community name:	

	year				year			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Inflation								
REVENUES								
Base sales price								
product type								
Options/Upgrades								
product type								
Total Revenues								
COSTS								
Land costs								
land price								
fees and legal costs								
Planning & Approvals								
Engineering, Consultants, Permits/Inspection								
Infrastructure cost								
Utilities and stree improvements								
Landscaping								
Recreation and common area								
Directconstructi on cost								
product type								
Option / Upgrade cost								
product type								
Selling and marketing expense								
marketing center construction								
marketing center ongoing expense								
advertising (per quarter)								
comissions (average, per unit)								
closing costs (average, per unit)								
Porperty taxes								
per lot unsold at Dec. 31								
Other								
Master Association & HOA								
Community Center								
G&A								
General and administrative Expense								
Net Pretax Income								
NPV								

Exhibit 9: Example of typical two-bedroom unit (Option A and B)



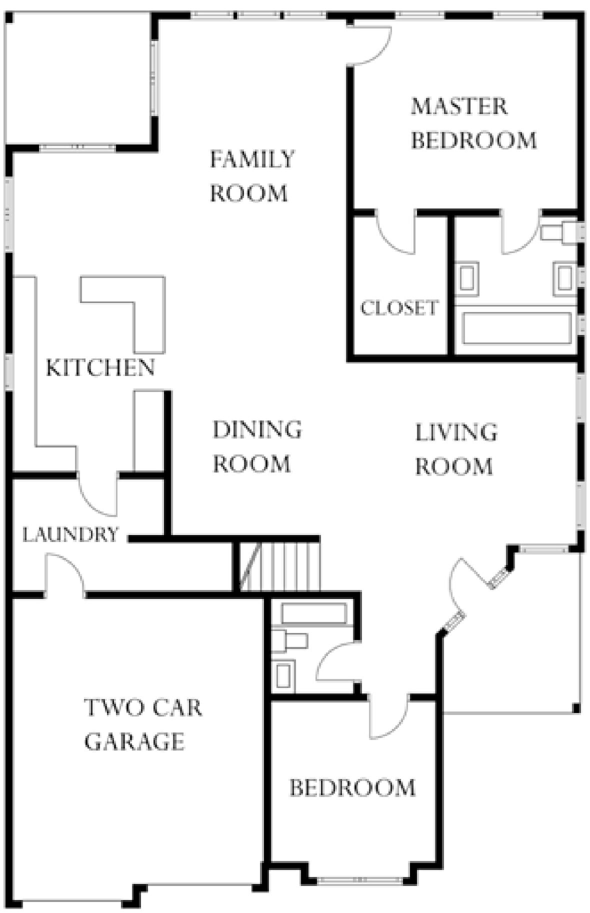
FIRST FLOOR



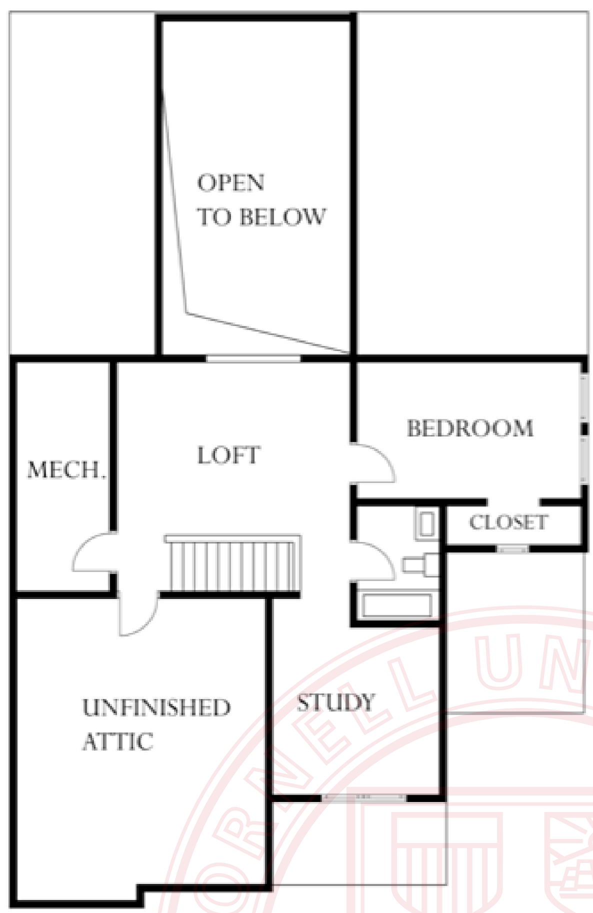
SECOND FLOOR

1,900 Sq. Ft. Total

Exhibit 10: Example of a typical three-bedroom unit (Option A and B)



FIRST FLOOR



SECOND FLOOR

2,630 Sq. Ft. Total

Exhibit 11: Example of a townhome unit (Option B only)

2,100 Sq. Ft. Total