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Real Estate Advisor

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Elliott Davis

Accountants and Business Advisors

www.elliottdavis.com

Stake a claim in the new land grab

Ready for some good news in the real estate arena? Commercial land values are on the rise, especially in areas of the country experiencing sustained job growth.

This trend is prompting some investors to invest in future growth by “land banking,” the practice of purchasing tracts of commercially zoned land in areas in the path of probable future growth. While this strategy requires the soul of a gambler, the payoff can be significant. And, if you understand how to bank on the right land, at the right time, you can significantly reduce your risk.

NUMBERS DON'T LIE

A quick look at the nationwide numbers demonstrates the strength of the commercial land sector as compared with residential property. A recent national market analysis by commercial brokerage Grubb & Ellis showed that the median cost per acre for single-family residential land sank from \$98,500 at mid-year 2005 to \$69,018 in the same period in 2006. Conversely, the report showed that, during that same period, the median price per acre for commercial land (retail, hotel, apartment and office properties) rose from \$159,753 to \$170,940. Industrial land, meanwhile, jumped from \$130,009 to \$165,162 per acre.

The key to successful land banking is, of course, buying land in areas that *really* will experience significant and sustained job and economic growth. At the moment, high-growth areas include some parts of southern California, especially the “Inland Empire” east of Los Angeles and including San Bernardino and Riverside. Parts of the South and Southwest are also experiencing considerable growth.

In fact, according to the U.S. Census Bureau, Florida, California and Texas will account for nearly one-half of the total U.S. population growth between 2000 and 2030, with most (88%) of the nation's growth occurring in the West and South. One particular standout is Florida: The Census Bureau predicts that it will push past New York to become the third most populous



state by 2011. The Bureau expects that Arizona and North Carolina will also see sustained growth, with Arizona's population increasing by 5.6 million and North Carolina's by 4.2 million.

If a state or region is experiencing sustained population growth, economic and job growth can't be far behind. For example, in its September 2006 report, *The Best States for Doing Business*, Forbes.com ranked Florida third in the “Business Growth Prospects” category and fourth in “Business Climate.” Texas ranked second and North Carolina fourth in Business Growth Prospects.

PATIENCE IS A VIRTUE

If you're looking for a quick turnaround, land banking may not be for you. Large-scale, successful land investors tend to hold property for unusually long periods, often keeping undeveloped parcels in their portfolios for five years or longer.

The trick, of course, is to keep the property until it's in the middle of a development boom. Then you'll have the option of selling the undeveloped land or upping the ante by developing the land yourself.

Developing the land yourself is riskier than taking the money and moving to your next investment,

but it could result in significant revenue generation. A retail complex or multifamily housing facility in one of the nation's high-growth areas could provide a secure revenue stream and — because property values in these areas should remain stable — eventually allow you to sell at a profit.

Moreover, you may be able to reap sizable tax savings by buying land and developing it through a separate corporation established to concentrate on development, rather than making improvements to property you already own. Be sure to consult legal and financial advisors about this somewhat complex land-banking tax strategy.

LAND-ING THE BEST DEAL

There are three things to consider when scoping out land as part of a land-banking strategy: location, location and location. Investing in parcels in high-growth areas with developed infrastructures can be money in the (land) bank. 🏠

FAMOUS LAND BANKERS KNOW WHAT IT TAKES

Several well-known personalities are dyed-in-the-wool land-banking proponents. Probably topping the list is billionaire Donald Trump, who for several years held one of the last large, undeveloped tracts of land in Manhattan. He eventually developed a little more than half the 100-acre space running from 59th to 72nd Streets into the \$3 billion luxury apartment complex, Trump Place.

Also on the list is the late Bob Hope. He bought close to 30,000 acres of land in Southern California, becoming the largest private landowner in the state. Howard Hughes, probably better known for his eccentricity, was also a dedicated land banker. In the 1950s he acquired a 22,500-acre tract of land in Las Vegas Valley, which today is known as Summerlin. By 2015 it's projected to be home to 160,000 residents living in 30 separate villages.

Before you invest, assess

Uncertain times call for careful analysis

In today's uncertain market, many investors rely on a development/leasing strategy — counting on long-term building revenue rather than profit from frequent turnovers. In this environment, it's crucial that any building you buy have a solid revenue stream, because it may be the factor that keeps you afloat for some time.



The first rule, of course, is to gain a complete view of the building's financial picture before you invest in it. So be sure you have all the data you need for your calculations, including real and projected rental income, maintenance expense, annual debt service, and tax liability. Acquiring that information will require full disclosure from the property's current owner(s). Once you have it, you and your CPA can crunch the numbers to determine if it's a good investment.

CASH FLOW MODEL

One time-honored means of determining a building's economic feasibility — which basically translates to its profitability — is projecting cash flow after taxes (CFAT). CFAT can become your viability barometer: The higher the figure, the better the potential investment.



The first step is to calculate the building's net operating income (NOI). NOI is the potential rental and other income, minus:

- ✓ Vacancy costs,
- ✓ Credit losses, and
- ✓ Operating expenses.

Then, the building's real estate taxable income is calculated by deducting these items from the NOI:

- ✓ Mortgage and construction loan interest,
- ✓ Recovery for improvements and personal property, and
- ✓ Amortization of loan points and leasing commissions.

The real estate taxable income is multiplied by the applicable marginal tax rate to arrive at the tax liability.

Going back to the NOI, the building's annual principal debt service component is subtracted to determine cash flow before taxes (CFBT). Subtracting the tax liability from the CFBT and adding any investment tax credit will result in the building's CFAT. Using a cash flow analysis worksheet, your CPA can quickly calculate a property's CFAT.

PEERING INTO THE FUTURE

Clearly, wise investing is largely about predicting future — as much as present — economic viability. This is especially true in today's market, where it's likely you'll hold properties for relatively long periods as you wait for a positive selling climate.

One way to gauge future value is by determining expected value (EV). This quantifiable method of risk analysis takes into account the values and probabilities of the possible outcomes, including best-, most-likely- and worst-case scenarios. You can use EV to analyze whatever type of value you want, such as NOI or CFAT.

EV is calculated by first multiplying each possible outcome's value by its probability to determine the weighted average for each. EV equals the total of the weighted averages.

GETTING THERE

There are myriad software applications to help you determine a building's real value and project future risk. Here are a few options for you to consider:

Argus Software (www.argussoftware.net.) produces a suite of widely used asset valuation tools. Its Realm Solution facilitates financial analysis, budgeting and forecasting.

On Target 3.01, from Advantage Software (www.invest-2win.com), includes a tool to facilitate property flipping and a national, updatable database of foreclosures.

Real Data (www.realdata.com) offers a real estate investment analysis solution and a new product that is designed specifically to measure and project the value of development projects.

THE RIGHT NEIGHBORHOOD

When it comes to the bottom line, one of the major factors influencing a building's economic *viability* is the economic *vitality* of the area surrounding it. So choose investments or development projects in neighborhoods, cities, states, regions (and, in these times, countries) that have rosy economic and employment forecasts. Combined with solid financial analysis and projections, this will help ensure that your next investment or development project will provide a dependable revenue stream for the long term. 🏠

Going green: It's getting easier and more cost-effective

As increasing attention turns to saving our planet, more and more builders and developers are coloring their development projects green. And as green — environmentally friendly, sustainable — building practices spread across the construction industry, it's becoming easier and more cost-effective to weave environmentally responsible development methods into even the largest projects.

GOING GREEN PUTS GREEN IN YOUR WALLET

All too often, we lay the blame for energy consumption and greenhouse emissions on the hoods of gas-guzzling vehicles. But, in truth, buildings — especially large commercial ones — are huge energy consumers. In fact, according to the U.S. Department of Energy, buildings consume 39% of the energy used in the United States, more than cars or manufacturing plants.

A March 2007 study by the United Nations Environment Programme reports that, “by some conservative estimates, the building sector worldwide could deliver emission reductions of 1.8 billion tons of CO₂. A more aggressive energy efficiency policy might deliver over two billion tons or close to three times the amount scheduled to be reduced under the Kyoto Protocol.”

There's a growing mountain of data indicating that environmentally responsible building

practices put green in your wallet — as well as in the environment. A recent study by the U.S. Green Building Council (USGBC), drawing on national data for 100 green buildings in the United States and reported on GreenerBuildings.com, demonstrated that initial investments in environmentally friendly building technologies and materials often pay for themselves within a few years.

MORE GOOD FINANCIAL NEWS

The USGBC report found that the financial benefits of green design — including cost savings from reduced energy, water and waste; lower operations and maintenance costs; and enhanced occupant productivity and health — are between \$50 and \$70 per square foot of a building adhering to the Leadership in Energy and Environmental Design (LEED) standard. That's more than 10 times the additional cost associated with building green.

The LEED standard was developed by members of the USGBC, representing all segments of the construction industry, including new commercial construction and major renovation projects, existing building operations, commercial interiors projects, core and shell projects, residential construction, and neighborhood development.

And there's more good news: Prices on environmentally sensitive materials, from recycled carpeting to paints that emit fewer toxic fumes, continue to decrease. The USGBC claims that building green often adds nothing to a project's cost; in cases where it does, the increase typically is less than 5%.

Most builders already use some green techniques — such as installing low-usage toilets and energy-efficient lighting. It's not, therefore, a huge leap to consider employing the full range of green building techniques.



TAP INTO GREEN MATERIALS AND SERVICES

As green practices spread across the industry, it's easy to find the materials and services needed to build environmental responsibility into development projects.

One comprehensive source for information about green building practices and listings of green service and materials providers is *A Sourcebook for Green and Sustainable Building*, offered by Green-Builder.com (www.greenbuilder.com/sourcebook). The USGBC also offers several resource lists at www.usgbc.org.

BUILD WELL, WIN BIG

Green building truly is becoming one of life's win-win situations. By building more responsibly, builders and developers can actually save money. Federal, state and private philanthropic programs are available to provide incentives for those developers that choose to build green.

To learn more about these options, contact your state departments of commerce or natural resources. These offices can help guide the interested developer through the various LEED designations and funding opportunities. 🏠

STRENGTHEN YOUR PORTFOLIO BY EXPANDING YOUR INVESTMENT HORIZONS

Through 2007 and into 2008, uncertainty is likely to color real estate markets, especially in the residential sector. Experienced investors and developers alike are dealing with the shifting ground by stepping outside previous comfort zones to include in their portfolios projects across the country and around the globe. They are also focusing on income-producing property as a hedge against changing tides in the marketplace.

A broader perspective

Domestically, strong real estate markets include Los Angeles and other port cities, which are enjoying growth thanks to the virtual explosion of the logistics industry. Other strengthening markets across North America include Ottawa, Phoenix, San Diego and Seattle, with secondary markets including Las Vegas, Orlando, Sacramento and Tampa.

Investors can further strengthen their portfolios by investing on a global scale. The United States lags behind much of the rest of the world in economic recovery, making some domestic investments less attractive than comparable projects in other regions.

For example, the retail and hospitality sectors are particularly strong in Asia-Pacific, which continues to be positively affected by the turbocharged economic engine that is the People's Republic of China. And Europe, whose economic recovery has been more robust than the upturn in the United States, currently boasts particularly strong office and condo sectors.

An income strategy

This is also a good time to expand investment horizons in another way: by adding income-producing properties to your portfolio. In an uncertain market — when you may have to hold property through soft periods — you can boost cash flow by investing in buildings that will work for you from purchase through sale. (For information on gauging the value of income-generating property, see "Before you invest, assess," on page 3.)

Generally speaking, investors should look to expand their horizons in 2007 and into 2008, by both seeking opportunities in new regions and/or countries and mixing more leasing and development projects into their portfolios.

Ask the Advisor

How do I know my warehouse is being assessed and taxed fairly?

If you've noticed that the tax assessment on your manufacturing or warehouse site has taken a huge leap, it's not because your local taxing authority is hiking your bill to fund a trip to Barbados. It's more likely that your tax collector is confounded by warehouses and industrial space, which are different animals from most other commercial buildings.

Let's take a look at how to help ensure your municipal tax department's assessment is accurate.

UNDERSTAND THE COST APPROACH

Chances are, you occupy the building yourself or lease it to a single lessee on a long-term lease. So, it's a pretty good bet that you're not planning to sell the facility anytime soon. Because industrial space like yours turns over so infrequently, reliable rental and sales data are rare commodities.

Thus, local tax collectors typically are unable to use the *income and sales* approach (calculating property value based on transactions involving similar structures), relying instead on the *cost* approach. And, unfortunately for you, using the cost approach can result in a high valuation and tax bill unless appraisers have correct, up-to-date and specific information about your building.

When appraisers use the cost approach, they seek to determine a structure's worth by starting with the value of land, then adding the cost to reconstruct any improvement, less depreciation. In your case, that "improvement" is your building. The formula they use — replacement cost new, less depreciation (RCNLD) — results in the final valuation.

OFFER SPECIFIC INFORMATION

Appraisers frequently fly blind when valuing industrial space, often using generalized data from commercial services in their computations. So, it's up to you to open their eyes by offering

the specific information they need, focusing on the deductions that apply to your building. Appraisers generally will consider the following deductions:


Deterioration.

This is a deduction for wear — and therefore loss of value. Let the appraisers know about any wear and tear that should reduce their valuation — and your tax bill. For example, if your business regularly uses heavy equipment, parking lots and access roads are likely to suffer significant wear.

Functional obsolescence. Appraisers may apply this deduction to account for changes in market design preferences. Provide the appraisers with a full list of modifications that would be required if you were building your facility today.

Economic obsolescence. This deduction involves expenditures for items that don't benefit the income-producing capability of the building, such as pollution-control equipment. Make sure the appraisers have a full list of all expenditures that aren't income-generating.

TRANSFORM YOUR TAX BILL

By working closely and cooperatively with your appraisers, you may be able to transform an unreasonable tax assessment into something that reflects the true value of your building. If the tax bill warrants it, you might also want to consider hiring a professional whose primary service is working with tax assessors to help lower assessments. If you're considering this option, talk with your CPA for more information. 



In the real estate industry, the numbers are big and so are the risks. Poor timing, bad advice, even small oversights can have substantial consequences. Whether you're a developer or an investor, Elliott Davis' Real Estate Group helps keep your business grounded.

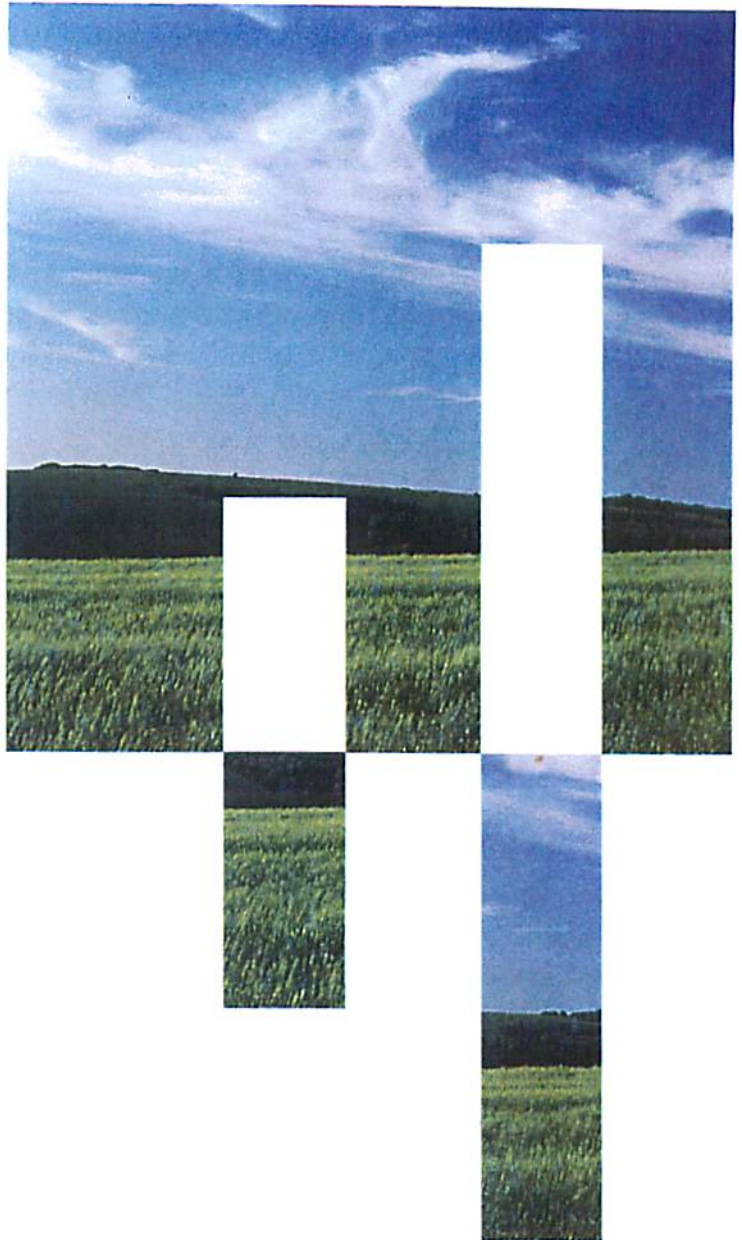
Our team puts its deep industry knowledge and experience to work for you with customized solutions based on your specific situation and requirements. With our network of locations throughout the Southeast we deliver personalized service wherever your business lands.

ACCOUNTING SERVICES:

Our team reviews your historical financial statements, evaluates trends, pinpoints strengths and weaknesses in your financial and operational business performance, and makes certain you're receiving the right kind of financial information to run your business and ensure tax compliance. We provide not only traditional credit, review compilation, and tax preparation services but also forecasts, projections and acquisition evaluation and accounting.

BUSINESS ADVISORY SERVICES:

Our Real Estate group helps you consider and structure various alternatives to maximize return on investment. A sampling of our services include: 1031 exchange consulting, cost segregation studies, revenue recognition and cost allocation techniques, tax credits, and business entity planning and organization choice.



To learn more about Elliott Davis and how we can help you position your company for sustained profitable growth and continuing success, call us at 800-503-4721 or visit www.elliottdavis.com.

Office Contacts

Greenville
Mark Cooter
864-242-3370

Augusta
Bob Wade
803-649-1500

Anderson
Mark Cooter
864-242-3370

Columbia
Darren Hardin
803-256-0002

Aiken
Bob Wade
803-649-1500

Greenwood
Bill Garvin
864-229-4951

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