EMERGING DEVELOPERS – Industry Cheat Sheet

ARCHITECTURE – *the process and the product of planning, designing, and constructing buildings*
- WHEN TO CALL:
  - If your project is a new build
  - If your rehab project requires a new layout or redesign with required code compliance

CIVIL ENGINEERING – *a process to determine the feasibility of a development project based on an assessment of the land*
- WHEN TO CALL:
  - If you are going through due diligence prior to acquisition
  - If you plan to rezone your land, re-plat, split lots, move dirt, or a have City/public entity that requires specific civil engineering plans for issuance of a permit

CONSTRUCTION MGMT – *project management to oversee the planning, permitting and construction of a project*
- WHEN TO CALL:
  - If you need a structure built, rehabbed, or repaired

CPA/COST SEGREGATION – *an accounting process that separates cost components of a building*
- WHEN TO CALL:
  - If you are tax planning to take advantage of depreciation, tax credits, or other incentives

DESIGN + BUILD – *a process that combines architecture + construction management through a single firm*
- WHEN TO CALL:
  - If you are seeking potential efficiencies or an “all-in-one” process for design + construction

INSURANCE (COMMERCIAL) – *the process to protect a project’s real property and improvements from potential losses*
- WHEN TO CALL:
  - If you are moving forward on any project to ensure that all liability is covered, both during construction and after project completion

LANDSCAPE ARCHITECTURE – *a process involving the design and management of the built and natural environment*
- WHEN TO CALL:
  - If you are seeking a specific natural or planned exterior aesthetic or landscape management plan

LEGAL (REAL ESTATE) – *project review from any number of legal standpoints*
- WHEN TO CALL:
  - If you are in need of contract review, counsel for tenant disputes, questions regarding land acquisition, and various other reasons to ensure all processes are fair and beneficial

LENDING – *the process to borrow funds from a financial institution or other source of funding for a project*
- WHEN TO CALL:
  - If you are seeking financing to fund a portion or most of your development project

PLANNING DEPARTMENT – *public departments dedicated to zoning, permitting, and other development-related oversight*
- WHEN TO CALL:
  - If you are seeking the acquisition of land to determine zoning and related site-specific requirements
  - If you are seeking a permit to rehab a building or new build and are determining required building codes

REAL ESTATE BROKERAGE/REALTY – *a licensed firm that specializes in real estate acquisition or leasing*
- WHEN TO CALL:
  - If you are seeking the acquisition of real estate or plan to lease a physical location
  - If you have leasable square footage and are seeking a tenant

STRUCTURAL ENGINEERING – *a process to design or determine the structural integrity of buildings and other structures*
- WHEN TO CALL:
  - If you plan to rehab older properties
  - If you plan to design a structurally intensive new build

TITLE – *a process to determine who has owned a property in the past and to ensure there are no liens against a property*
- WHEN TO CALL:
  - If you plan to acquire any real estate and improvements

EMERGING DEVELOPERS – Must-Know Terms

Acquisition cost. The total price, including all fees (mortgage, closing costs, inspection fees, etc.) required to purchase an investment property.

After repair value (ARV). After-Repair-Value or ARV is the estimated value of a real estate property after all the renovations have been completed. ARV is used by real estate investors to compare a property's all in costs and what the property value should be when the project is complete.

Bridge loan. A short-term loan a developer takes out against their property to finance the purchase. It is an interim financing before the next stage of financing or to cover an interval between two transactions. A Bridge loan is usually taken out for a period of a few weeks to up to three years and the money from the new financing will be used to pay back the bridge loan.

Cap Rate. Capitalization rate, or cap rate for short, is used to measure the annual rate of return on a real estate investment based on the profit that property is expected to generate. Simply put, it's the ratio between the net operating income (NOI) and purchase price. Cap rate is calculated by dividing net operating income (NOI) in the first year by the property purchase price. (NOI excludes loan costs if you used financing). In theory, cap rates can signify varying levels of risk. Higher cap rates may correlate to a higher amount of risk in the purchase.

> The calculation: Say you purchase a property for $150,000. The expected NOI in the first year is $12,000.
>
> $12,000/$150,000 = 0.08 Therefore, the Cap rate is 8%.

Capital Stack. A capital stack is the legal organization of all the layers of debt that are used to purchase, build, or renovate a piece of real estate. It outlines who will receive income and profits generated by the property and in what order. The capital stack also defines who has the first right to foreclose on the asset as collateral in the event the equity owner defaults on the mortgage. The position of a piece of debt in a property's capital stack determines the order that lenders will be repaid in the case of a borrower default or bankruptcy.

The capital stack is typically comprised of four sections in the following order: **common equity, preferred equity, mezzanine debt, and senior debt**. Although common equity is listed first in the stack, it holds the lowest priority, meaning common equity lenders are paid last. Senior debt, at the bottom of the capital stack, holds the strongest priority, meaning senior debt lenders are the first to be paid. While each investment level comes with its own risk and reward, the higher positions in the capital stack typically earn higher returns as a result of their higher levels of risk.

1. **Senior Debt:** Senior debt holds priority over all other positions in the capital stack. In other words, senior debt lenders are to be paid before any other investor is given a return on its investment. The senior debt in capital stack typically refers to the mortgage lender or some other debt holder who has the highest claim on the underlying asset. This is the least risky position to be in because, if the borrower fails to make the mortgage payments, the lender can take over the property ownership through a foreclosure action and sell the property to recover the amount owed.
    - If an investor is trying to understand the risk involved in a commercial real estate investment, among other things, they should look at the loan-to-value ratio (LTV). The LTV is the amount of debt on a property relative to its overall value. If the loan has 65 percent LTV, there is a lot more room for error than an 85 percent LTV loan because, as the lender, you would much rather end up owning the property at 65 percent of its value than at 85 percent, if forced to foreclose, in order to recover the capital loaned. Senior debt typically comprises 60-75 percent of the total project cost though this can vary depending on the risk profile of a building, the stage of a cycle, and the creditworthiness of the borrower. Senior debt typically receives the
    - lowest return of any other position in the stack.

2. **Mezzanine Debt:** After all operating expenses and the senior debt payment have been made, any excess cash will go to servicing the mezzanine debt. For that reason, it is second to senior debt in order of payment priority and in its position in the capital stack. Because of its secondary nature, mezzanine debt will usually have a higher rate of return than senior debt.

3. **Preferred Equity:** Preferred equity is a somewhat vague term in the capital stack because it has come to take on different characteristics in recent years. Historically, the term was used to describe a type of capital that works similarly to common equity but has superior payment rights. However, since the Global Financial Crisis, it has morphed to function like subordinate debt and receives a fixed return without any share of profits, but with enhanced rights to take over a project in the event of default. This evolution stems from a realization by lenders during the Global Financial Crisis that mezzanine lenders had greater rights than expected which complicated first position lien holders' recovery efforts when borrowers defaulted. To prevent this from happening again, lenders increasingly

prohibited the use of second position loans, including mezzanine debt. To replace it, preferred equity was restructured to fill the same gap in the capital stack, but designed not to look like (or be called) debt, but to function as close as possibly to debt as first mortgage lender requirements would allow.

4. **Common Equity.** Lenders typically require developers or sponsors to contribute some of their own money into an investment via common equity – colloquially known as ***'having skin in the game.***' Common equity is provided by the individuals who operate the property on a day to day basis, the sponsor or operator, and their investor partners, and is the riskiest yet potentially most profitable portion of the capital stack. Common equity holders get paid after all other parts of the capital stack and preferred equity investors have received their agreed-upon returns, making common equity holders last in priority. Although not guaranteed, common equity holders are entitled to recurring payments from the property's cash flow after all other capital holders have been paid. This is typically paid in the form of a preferred return on their investment which is paid for out of available cash flow once all other creditors loan servicing has been made. In addition, common equity holders participate in property cash flow distributions, if any. If the property does well, equity investors typically do not have a cap on their return potential.

Cash flow. The amount of money that an investor can take home at the end of each month after payment of all operating expenses, including loan payments. Cash flow can be either positive–if you spend less than you earn, or negative—if the spending is more than the earnings.

Cash on cash return (CoC). CoC is cash flow before tax, a pre-tax calculation that measures the percentage of return on the actual cash invested in a property, which is used to assess or analyze the potential investment opportunities. **C**ash-on-cash return only measures the return on the actual cash invested. It's the cash you've got left after one year, divided by the cash you've invested.

Closing. The final stage of the real estate transaction, the closing date is agreed upon by both the buyer and seller to legally transfer the property from seller to buyer.

Commercial Real Estate. Commercial Real Estate (CRE) is income-producing property that falls into the main categories of land, industrial, retail, office, special use (such as a gas station or government building), and larger multifamily apartment buildings. By contrast, Residential Real Estate includes property such as single-family homes, townhomes, condominiums and co-ops, and smaller multifamily property with two to four units.

Comparable sales. Also known as 'comps', comparable sales are used by real estate investors, funding sources and appraisers to assess how much a property is worth based on what other similar properties in the area have sold for recently. These are properties that have sold in the neighborhood and are comparable in property age, condition, size, and style. Only properties that have legally closed typically count and most lenders and insurance providers require appraisers to use at least three closed sales.

Credit score. A number between 300 and 850 that depicts the creditworthiness of an individual based on an analysis of their credit history. It is usually used by lenders to determine if someone qualifies for a loan, the credit limits, and interest rate.

Debt-to-Equity Ratio. Debt-to-equity (D/E) ratio is a measure of ownership. This ratio helps you determine how much of your property is actually yours (if you took out a mortgage to finance it) and how much you owe in debt.

Discount Rate. The discount rate is the interest rate the Federal Reserve charges commercial banks and other financial institutions for short-term loans. The discount rate is applied at the Fed's lending facility, which is called the discount window. A discount rate can also refer to the interest rate used in discounted cash flow (DCF) analysis to determine the present value of future cash flows.

Discounted Cash Flow Analysis. DCF is used to estimate the value of an investment based on its expected future cash flows. Based on the concept of the time value of money, DCF analysis helps assess the viability of a project or investment by calculating the present value of expected future cash flows using a discount rate.

The analysis begins with an estimate of the investment that a proposed project will require. Then, the future returns it is expected to generate are considered. Using the discount rate, it is possible to calculate the current value of any future cash flows. The project is considered viable if the net present value (PV) is positive. If it is negative, the project isn't worth the investment.

Equity. The property's present market value minus any outstanding mortgage amount that exists. Equity is the percentage of the property that a property owner owns because while he is considered a property owner, he does not own the property fully. The more he pays down the mortgage balance and the more the property appreciates over time, the more equity he has in the property.

Hard money loan. An asset-based loan issued by private lenders. Typically, quick to fund but have higher interest rates than conventional loans. This short-term loan that is used to acquire and rehab investment properties. Hard money loans typically fund 100% of repair costs and ~90% of acquisitions costs.

Internal Rate of Return (IRR). The internal rate of return (IRR) is a metric used in financial analysis to estimate the profitability of potential investments. IRR is a discount rate that makes the net present value (NPV) of all cash flows equal to zero in a discounted cash flow analysis. Generally speaking, the higher an internal rate of return, the more desirable an investment is to undertake.

Loan-to-value ratio (LTV). The ratio that lenders use to measure the amount of the loan compared to the value of the property and to assess the overall risk before approving the loan. Loan assessments with higher LTV are higher risks and thus would require higher interest rate or may require the borrower to purchase mortgage insurance. Lower LTV would require borrowers to come up with larger down payments.

The formula for computing LTV is: The LTV = Mortgage amount ÷ appraised property value (or sale price)

Loan origination fee. The amount charged by the lender for processing your loan. This includes evaluating, underwriting, and submitting your loan. Typically, the charge is 1% of your total loan balance.

Long-term rental. The traditional type of rental property where tenants sign a lease for a longer period of time typically 1 year or more.

Short-term rental. Short-term rental property is a furnished living space; a type of rental property only leased for a short period of time usually less than 3 months for pop-up/test concepts.

Multi-family property. A residential property designed with more than one housing unit to house different tenants in separate units. Good examples are duplex, townhouse, or apartment complex. The owner can choose to occupy one of the multi-family units and this is referred to as owner-occupied property.

Net Operating Income (NOI). Total income less operating expenses, adjustments, etc., but before mortgage payments, tenant improvements and leasing commissions.

Single-family home. A free-standing residential property designed as a single dwelling with its own land, no shared walls, and unattached to any other residential or commercial properties.

Off-market property. A property that has been sold or is in the process of being sold without any public knowledge or advertisement. Off-market properties are not listed on the public multiple listing services for sale. Reasons for off-market sales include maintaining privacy, creating exclusivity, or even to save on commissions.

Pre-approval letter. A letter offered by a lender before you start looking for a property or apply for a mortgage to determine what you can afford. It assures property sellers that you can be granted a loan when needed.

Proof of funds. A document that demonstrates a person's capability to pay or the availability of funds for a particular transaction. It could be a statement from a financial institution that the buyer has enough funds to proceed with an offer to the seller.

REIT. A Real Estate Investment Trust is a company that buys and operates income-generating real estate properties using investor money. It is just like mutual funds, except the company holds individual properties in a trust, rather than stocks and bonds. There are different kinds of REITs that you can invest in. Some REITs include retail, residential, healthcare, office, and mortgage.