

**Entitlement Advantage:
The Balance of Local Knowledge and Capital Access in Real Estate Entitlements**

By
Scott Edward Kelley
Bachelor of Arts, Architectural Studies, 1997
Brown University

Submitted to the Department of Architecture in Partial Fulfillment of the Requirements for the
Degree of Master of Science in Real Estate Development
at the
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Signature of author _____

Scott Edward Kelley
Department of Architecture
July 27, 2007

Certified by _____

Lynn Fisher
Assistant Professor of Real Estate
Department of Urban Studies and Planning
Thesis Supervisor

Accepted by _____

David Geltner
Chairman, Interdepartmental Degree Program in
Real Estate Development

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Abstract

Development is risky. The process of getting a shovel in the ground, steel into the sky, and rent checks into the bank involves distinct phases, each with their own risk and return profile. Generally considered the most risky, the entitlement phase is process by which the development entity gains the legal right to parcel land and develop a prescribed structure. This process sits at the confluence of all development factors: local politics, due diligence, financial support, and patience.

The purpose of this paper is to identify the critical organizational structures and human capital required to reduce entitlement risk. It begins with an overview of the definition of entitlement risk by generating a connection between financial projections and the idiosyncratic entitlement process. Risk in the entitlement stage is a function of control. The entitlement process has become increasingly complex in the last few decades with landowners and developer faced with diminished control over land destiny. The study follows with a review of reported best practices enlisted by developers to alleviate the risks in the entitlement process.

A paradox exists in real estate entitlements where the local player is advantaged by local information and connections, but may lack capital while the national player is advantaged by capital access, but may need local information and connections. The existence of this paradox would suggest that national firms engaged in entitlements would adopt organizations and strategies to help alleviate their weaknesses. Indeed, this is the case, as evidenced by the five subject firms whose organization, strategy, partnering, geographic focus, and returns are discussed and compared. Ultimately, firm structures of national players not only succeed in diminishing the advantage of the local player, but do so in a fashion that brings exceptional returns that meet the stringent expectations of their varied investors.

Thesis Supervisor: Lynn Fisher
Title: Assistant Professor of Real Estate

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Chapter 1 - Introduction

Thesis Motivation

Achievement of land entitlements, the rights granted by local regulatory bodies to build a project, often represents the greatest act of value creation within the development lifecycle. Capitalizing on this stage requires navigating emotions, legal rights, and input from many stakeholders. As real estate is location specific, the local developer has had the historic upper hand in entitlements.

Local information is important in two ways. First, it helps in properly gauging land value and potential in relation to market and social dynamics. Second, the local player is better positioned to know local politics, the political personality of a community, and power bases which would aid or hinder the entitlement process. The two considerations are not mutually exclusive as knowledge of political undercurrents in a community might dictate an unconventional project proposal that is more likely to be approved. This can prevent unrealistic expectations about the ultimate land value. Also, a local player may benefit from a greater level of trust. Entitlements often entail promises made by the developer to the community. Stakeholders are more likely to trust a community member than a non-local entity that may be suspected of "flipping" entitled land.

This may be the result of the following:

- perceived land scarcity leaves many concerned about open space
- the human experience seeks consistency and resists change
- increased environmental awareness is at odds with new development, especially in land constrained areas where new development may interface with wetlands, for example
- a dramatic elevation in property values in much of the country over the past ten years has made real estate a national past time

An agitated and informed public will rally to maintain their surroundings. Because the home is often the biggest asset in a homeowner's wealth portfolio, there is an inclination to protect negative affects on its value. Any proposal that requires a variance, a zone change, or an innovative mixed use will entail a lengthy process under public scrutiny regardless of whether

the developer is local or not. Because time is money, the advantage may ultimately lie within the deep pockets of national firms lined with institutional capital.

Institutional investing in real estate has evolved over the past 20 years, particularly in reference to acceptable asset classes and increasing risk comfort. Investors initially sought "safety" and leaned towards investing in operable and stabilized assets, such as Class A office buildings in first tier cities. Competition reduced returns on these investments and has resulted in institutional capital being forced to find comfort in higher risk investment strategies. Class A investments were followed by land acquisitions and holds, and then investing in development projects themselves.

Only recently, institutional capital has begun to invest in the entitlement process itself, the phase representing the greatest uncertainty and most risk. From an investment perspective, participating in the entitlement process entails a capital investment that yields zero cash flow until the entitled asset is either developed or sold, thus requiring patient capital to participate. The presence of investors like CalPERS, and other large pension funds, suggests a level of comfort in entitlement investing that has been missing in the past. Clearly, pension managers believe the skills and resources these firms bring to the process provide the safety net required to satisfy investment mandates of pension fund money. Suggestions from industry interviews to follow indicate that entitlement investment is becoming another layer in the diversified portfolio.

While "vulture" and "opportunistic" funds have long existed for real estate, the difference represented by these new entitlement funds is the involvement of institutional investors who bring greater amounts of capital. The size of these "entitlement only" accounts demand a systematic and professional approach. These demands move the process away from the local developer who may be enduring an entitlement process to produce a "one off" development. Funds raised in the past few years are in the \$500 million to \$1 billion range and are being applied to entitlement processes throughout the country by specialized firms. These firms are noteworthy in that management is forced to locate and execute projects beyond the boundaries of a single local market. Considering 73% of the population opposes development, in a process that requires local approval, might suggest an outside or foreign entitlement entity would have a

diminished chance of success?¹ Apparently not. These funds are witnessing healthy returns and the fund managers are crafting winning strategies that merge their pocketbook with the connections of local partners to result in entitled projects.

In the individual asset market there may be information asymmetries which work in favor of the local party who seeks to entitle land. Location specific information may make it difficult for outsiders to value the asset or fully understand the political realities that will influence the outcome of an entitlement application. But technology can help undermine much of the market based local knowledge by providing access to sales, assessments, and market trends. Avenues for acquiring information are greatly widened with extensive blog and on-line content accessible about seemingly any topic.

Entitlements focus on turning raw land into assets. Land is limited in its use as an investment vehicle. Unlike operating assets, land must overcome a series of characteristics that reduce its appeal. The drawbacks include:

- Negative cash flow
- Limited tax advantages due to the inability to depreciate land
- Land is generally an illiquid asset that requires time for gains to be realized
- Resale loss is a possibility; particularly since raw land value is difficult to determine
- Traditional financing is difficult
- Borrowing against accrued equity is difficult
- Information asymmetries can provide a competitive advantage to one of the parties
- Agency issues that may result from the necessity of acting on third party opinions

The financial implication of these drawbacks is the need for patient capital to extend the time constraints further suggesting the competitive advantage of institutional capital. Also, risk may result from organizational strategies of firms. While some may be geographically focused and be exposed to entitlement risks in particular areas, other larger firms may achieve a portfolio affect created by projects attempted in a broad marketplace.

¹ www.tseg.biz

The resulting hypothesis states that there are tradeoffs in determining the success of different types of projects undertaken by various investors. Local actors may be better able to value assets and less expensively obtain entitlements. Alternatively, institutional capital may be of lower cost than the funding accessible to local players due to financial engineering. This capital may be equity rather than debt, have patience, or simply be supplied at a lower rate. The institutional capital funds may be better diversified and be better positioned to accept more risk as a result of the idiosyncratic risk evident in entitlements where returns are not highly correlated across markets.

If this hypothesis is true, there would be an expectation that these tradeoffs would be revealed in the organizations and strategies of the firms managing institutional capital, the subject firms in this thesis. The resulting questions are what type of organization these firms have, their methods of acquiring local knowledge, how they gain local credibility, and in what type of projects they participate?

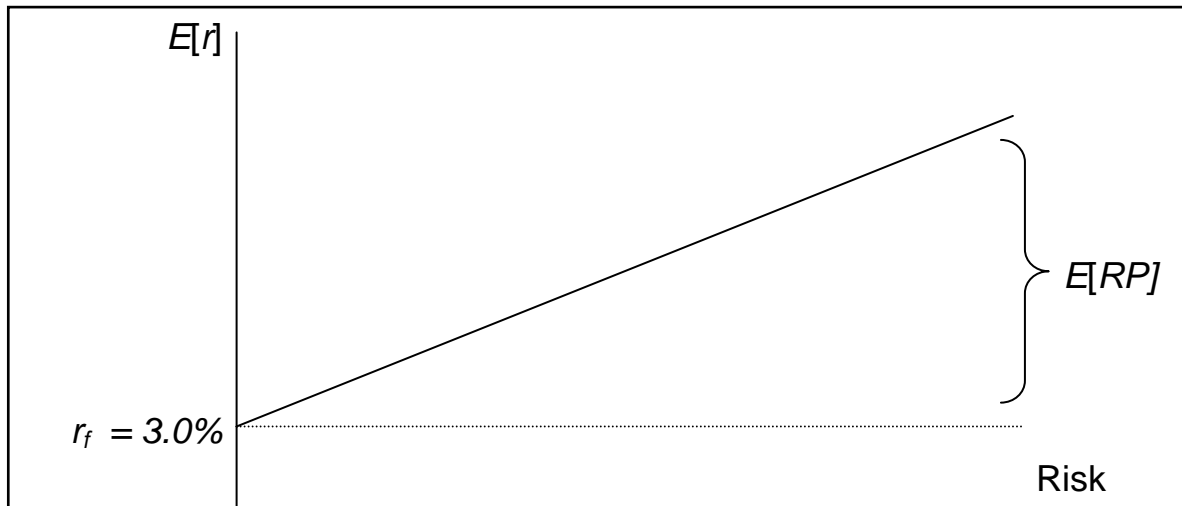
Methodology

This thesis was conducted using a qualitative approach. Primary data was derived from industry and popular press, scholarly articles, theses and dissertations, as well interviews with industry representatives. Selection of subject companies was made based on their size and interaction with the entitlement process. In addition to primary participants, valuable perspective was provided by Bob White at Real Capital Analytics and Micolyn Yolanis at The Townsend Group. These individuals provided cues on the players, expectations, and changes witnessed over the past five years as greater levels of institutional capital has chased entitlement-only investments.

Chapter 2 - Defining Risk in the Entitlement Process

Land and Risk

Risk, for the purpose of this investigation, means the inability to guarantee returns. The interaction between risk and returns is a fundamental financial concept which is easily illustrated. Simply put, as risk increases, so must return expectations.



The Geltner/Miller risk and return graph illustrating that the expected return $E[r]$ grows as risk grows. Risk is measured above a "risk-free" rate, here at 3.0% which reflects the ability to generate risk-free returns from stabilized securities such as a U.S. treasury bill.²

Institutional investors have historically shied from entitlement risk because there was little research that investigated the true parameters of risk involved, and was therefore difficult to anticipate returns. Perhaps the memory of ill fated opportunity funds in the late 1980s had caused institutional investors to avoid higher perceived risk through the 1990s. As recently as ten years ago, investors were too timid to incorporate even pre-entitled land parcels in their portfolio. However, the growing global investments and diminished returns have forced many of these entities to participate in projects featuring higher perceived risk. The change has been swift.

In 1996, Professor David Geltner with JoAnn Hanson and Donald Loeb, published an article in *Real Estate Finance* that explored the risk and return characteristics of pre-entitled urban land.

² David Geltner, Norman Miller, Jim Clayton, Piet Eichholtz. *Commercial Real Estate Analysis & Investments*. Second Edition. Thomson South-Western, 2006. p186.

The investigation sought to reconcile the absence of this asset class in the institutional portfolios. It was reasoned that the apprehension over land volatility was due to a lack of empirical evidence and research. The findings of the repeat sales index conducted by Geltner, Hanson, and Loeb revealed, using a Sharpe ratio, that the risk adjusted return on land was higher than other assets and only slightly more volatile than the S&P 500. The dataset of 48 transactions revealed that pre-entitled developable land in investment grade locations generated a nearly 27% return. Other asset classes ranged from 3% to 9%.³ The authors conclude with a recommendation for pension funds to consider including land as part of their investment portfolio.⁴

While research and indices may be a step in the right direction, institutional capital remained hesitant for two reasons. First, real estate markets are informationally inefficient in that all pertinent information may not be immediately reflected in prices. This inefficiency takes the form of valuation noise and market inertia. Valuation noise is due to the inability to pinpoint the true market value of a unique asset. The less frequently an asset type is traded, the less efficient we imagine prices to be. Minimally, parties must either research or pay a third party to acquire the information required to form price expectations. The slow recognition of information resulting from this inefficiency creates market inertia, which can be valuable, however. Future asset prices in the near term may be more predictable. This enables an investor to better capitalize on market timing than would be possible in the stock market, for example.⁵ The transaction costs of acquiring information in these markets, however, is generally believed to offset the potential gains.

The second remaining concern preventing adoption of land in the institutional portfolio is illiquidity. Investment managers must be able to easily buy and sell assets in order to guarantee returns, and the lack of this ability in real estate separates it from more liquid securities. Information inefficiency and illiquidity are symptoms of all real estate classes but may be more pronounced with land. Without cash flow and due to its location uniqueness, land price is often relative. Indeed, many developers do not start a pro-forma with a base land price, but rather back

³ David Geltner, JoAnn Hanson, Donald Loeb. "Land Investment in the Institutional Portfolio: Evidence from an Historical Return Index" *Real Estate Finance*, Volume 12, No. 4, Winter 1997. p84.

⁴ *Ibid*, 85.

⁵ Geltner, *et al. Commercial Real Estate Analysis & Investments*. Second Edition. Thomson South-Western, 2006. p274

into the price after establishing market conditions, product type, and construction costs. Land can be more illiquid than built assets because its true value is leveraged with improvements. A frequent strategy of developers to option rather than purchase parcels and make closing the option contingent on receiving appropriate permits illustrates this point.

The study of Geltner, *et al*, doesn't even entertain the possibility of institutional investment in un-entitled parcels. As of 1996, this must have remained unlikely. A decade later, the compressed returns of institutional portfolios has resulted in an interest in un-entitled parcels. But, like all risky endeavors, there needed to be a commensurate return.

One could argue that informational inefficiency and illiquidity may create an advantage for local players. A 2004 study by Garmaise and Moskowitz indicates informational asymmetries are resolved by market participants through the purchase of nearby properties.⁶ A 2001 study by Coval and Moskowitz indicated geographic implications in the mutual fund industry, finding that fund managers earn abnormal returns in nearby investments.⁷ The advantage of the local player appears easily undermined by the use of a third party. The Garmaise/Moskowitz study revealed that in markets with severe asymmetries, informed brokers sell to other informed brokers. The broker can serve as information proxy for the uninformed foreign party.

The method by which investors fund un-entitled projects further illustrates their growing comfort for riskier endeavors. Investors can contribute equity or debt to land deals. Debt used for acquisition benefits from the land as collateral. Invested equity, however, may serve as entitlement working capital and lack any recourse to the land. The participation of traditionally conservative investors in a market without collateral further underscores the evolution of un-entitled land as an asset class.

⁶ Garmaise, Mark and Moskowitz, Tobias. "Confronting Information Asymmetries: Evidence from Real Estate Markets" *The Review of Financial Studies*. Volume 17, No. 2, 2004. p405.

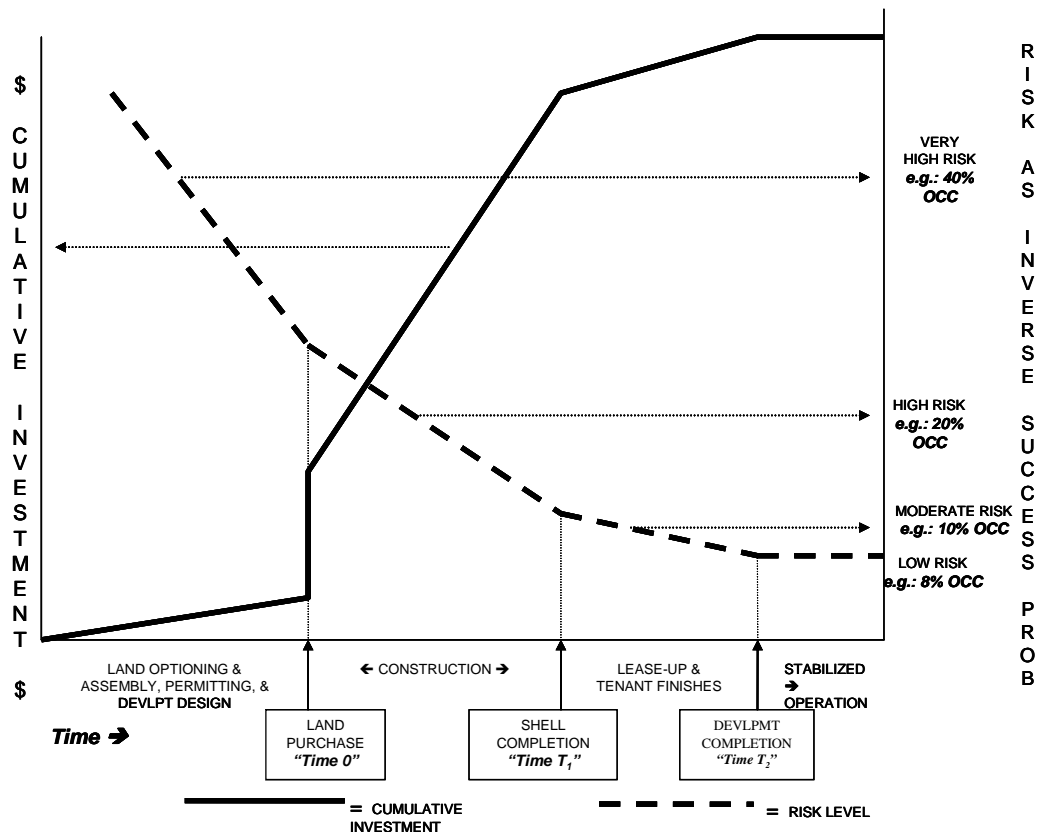
⁷ Coval, Joshua and Moskowitz, Tobias. "The Geography of Investment: Informed Trading and Asset Prices" *The Journal of Political Economy*. Volume 109, No.4, August 2001. p811.

Perceiving Risk

Parsing risk into its relevant stage of the development process appears to elude much of the development literature. This is due in part to the nature of traditional development where one development entity may take on the entire process. This may blur the risk and return features of the phases and make it difficult to do a true accounting of both where the risk resides and its potential detriment to the project. Un-blending the risk requires first identifying the stages of development and then using a metric to relate risk and return.

The Process

An elegant depiction of the risk and return relationship in the development process is provided by the following graph depicted in *Commercial Real Estate Analysis & Investments* and credited to scholar Tod McGrath.⁸



⁸ Geltner, et al. *Commercial Real Estate Analysis & Investments*. Second Edition. Thomson South-Western, 2006. p759

The graph depicts the development process as a distinct series of phases. It starts with the land optioning, assemblage, and permitting phase, then moves to the construction phase, and finally the tenant fit-out and leasing phase. Beyond this point the project is in stable operation. The dotted line represents the risk involved in the project as it relates to the probability that a project will reach completion. The solid line indicates the capital requirements for the project starting with little during the permitting phase, jumping at time of land purchase, and increasing as construction continues. This illustrates that although initial capital investment is low, risk is high. As the development team moves through the project execution, this relationship flips. Geltner contends that regardless of whether a developer recognizes these stages, they are present in any development project. A deeper look at each phase follows.

Preliminary Phase

The preliminary phase of development provides the greatest opportunity for creativity and entrepreneurship. Unusual land use, clever mixed use projects, and seeing opportunity where others see problems are the value generators of this phase.

In traditional development, this phase begins by gaining control of the land. Options, or the right to purchase, without obligation, a given parcel of land at a pre-determined price, provide protection from competitors and gives the developer time to conduct due diligence. Option agreements will often include extension clauses. This benefits the developer for two reasons. First, the due diligence period is highly unpredictable. Second, the ideal time to develop a parcel is not always immediate. Savvy developers can assess the best development timing using option valuation theory.

Concurrent with land optioning and assembly, the development team will be designing the project to respond to market conditions and the parameters of underlying municipal regulations. Extensive refinement may be needed to respond to the rigors of the permitting process.

Because the developer is subject to approvals of others, risk is highest at this time. Under the Geltner model, it is suggested that the opportunity cost of capital for this stage is as high as 40%. This percentage reflects the relationship of this stage to the project's overall probability of success. This phase may speed by in a matter of months or require decades to complete.

The heavy solid line in the above graph depicts the cumulative investment in a subject project. One can note that although the preliminary phase is high risk, it typically does not involve a heavy outlay of capital. This provides a safety net for developers who may learn at any point that a project will be infeasible, requiring them to abandon the project and accept the sunk costs as losses.

The nature of cash outlay in the preliminary phase enables these sunk costs to be low compared to the overall project costs, however. This phase of development entails developer "sweat equity". The developer may be tracking several potential projects simultaneously in hopes of proceeding with one through to construction. These sunk costs are often recouped as fees for construction and asset management once the project breaks ground.

The goal and result of the preliminary phase, entitlements, may create the biggest jump in value in the entire development process. The increase in value is subject to the inherent risk of the entitlement goals. Naturally, the entitlements of a residentially zoned parcel into a residential subdivision may be less cumbersome entitlement than one involving change of use or a zone change overlay. Still, suburban land optioned for a residential subdivision easily jumps 100% in value when entitlements are secure. It is not uncommon to see the value of entitled urban locations to jump 500%.

Construction Phase

Risk is greatly reduced in the construction phase for two reasons. First, project inertia benefits from having entitlements in hand and getting a shovel in the dirt. Unanticipated delays are more likely to come from construction difficulties than agitated abutters or other political risk. Second, the majority of construction costs in this country, even in projects executed by well capitalized firms, are paid through construction loans. These loans require third party oversight before disbursements and this contributes to a reduction in risk.

Risk that remains is the result of speculation and operational leverage. In speculative projects, the developer accepts significant market risk due to uncertain occupancy. Unsigned lease

agreements provide no protection from construction expenditures. Also, new buildings contain operational leverage, or high fixed and committed costs relative to the potential revenue. Even with an all equity project where there is zero financial leverage, a developer still faces the unknown carrying costs of a unique asset. This is the case even with a fully pre-leased building. The investor/developer has committed to paying development costs regardless of the final asset value. To compensate for risk in the construction phase, developers would likely consider a 20% opportunity cost of capital during this period.

Lease-Up Phase

Risk is lowest during the lease-up phase. This stems from the fact that the building is largely complete and can accommodate tenants. New construction may benefit from tenant desire to be either in a new building or have the ability to move into a contiguous space. Risk that remains is likely tied to market conditions. Class A office buildings, for example, require significant development time and may come on-line during a market trough. However, even if a building comes on-line during the depth of a market cycle, it may soon have an advantage when the market shifts as one of few available options in a warming market. Risk in lease up, therefore, is less than the other phases. Indeed, a 100% pre-leased property with a triple net lease where tenant fit-out is the responsibility of the tenant would represent a very low risk scenario. This portion of the development is the least risky and the opportunity cost of capital will reflect this with perhaps a 10% OCC. Once leased, the project enters stabilized operations which features still lower risk, perhaps an 8% OCC.

Residential Note

In the residential market, the risk profile illustrated in the graph may drop dramatically during the construction phase. This is due to the tradition of pre-selling units as a means of providing buyers the option to help design their homes. If a homebuilder and buyer come to a purchase and sale agreement prior to construction, the risk profile would be more in line with a pre-leased office building and essentially eliminate market risk.

The Canonical Model

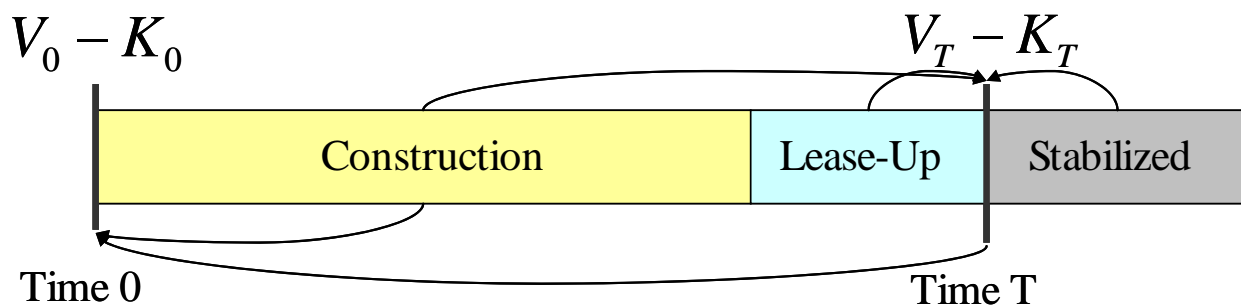
The traditional view of the development process places the developer at helm of a process where they may do everything from site selection to leasing. Participating in every stage enables the developer to recapture losses experienced in one phase by making adjustments in a later stage. For example, unforeseen site issues that require more pilings may represent a significant surprise cost in the construction phase. The developer may be able to adjust his finish selection, landscaping, or adjust some other variable in a way to recoup this loss.

The entrance of institutional investment in the entitlement phase, however, demands the ability to forecast and compartmentalize the risks associated with each phase. An entity that is participating in the entitlement process only is unable to recoup lost revenue later in the project.

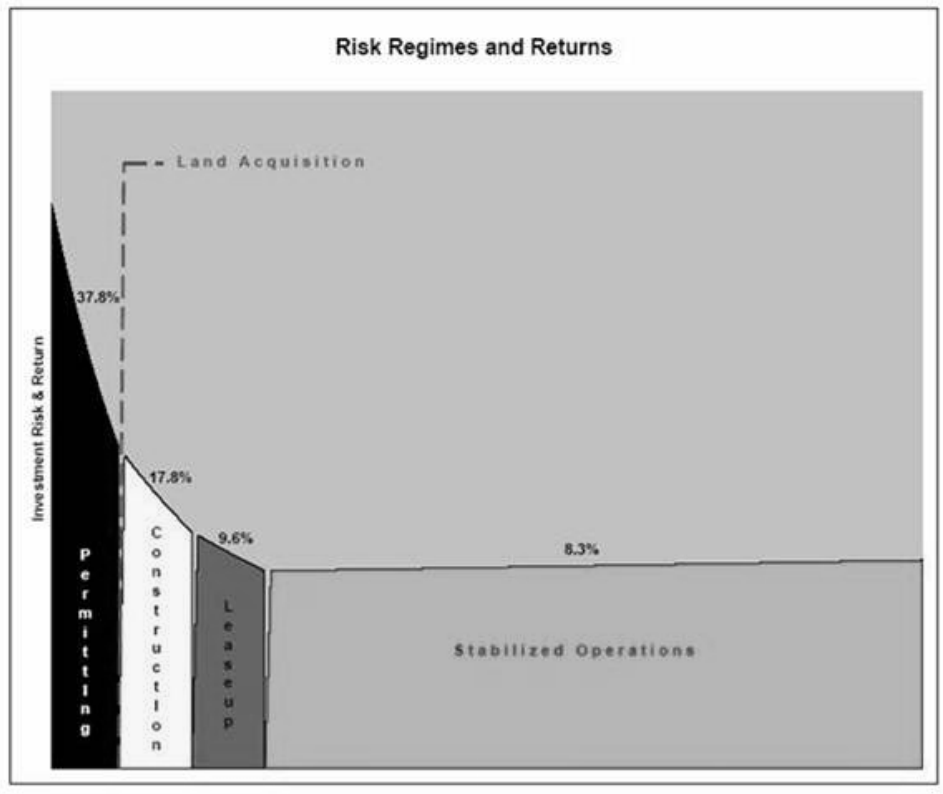
Professors Geltner and Miller elaborate on the relationship of risk and the development process in the book *Commercial Real Estate Analysis & Investments*. Within the text, the authors assert that one can quantify the risk and returns of the development phases using their *canonical model*. This type of analysis enables the analyst to "un-blend" the IRR of the development. Using this device, cash flows are grown or discounted to two points within the development, Time 0 and Time T. By compartmentalizing the process in this fashion, the analyst can apply phase specific adjustments and determine the risk and return expectations.

Time 0 is the point when the irreversible decision is made to purchase land and commence construction. Land can be acquired directly prior to development or may be the result of speculation, land banking, or inheritance. In circumstances when land was acquired prior to development, the value of the land is grown to Time 0. The development entity must recognize that the monetary value at Time 0 can be quite different from historic costs, and the true value may incorporate value generated through permitting and assemblage. In situations where the land owner is uncompensated for this difference, they should be considered development partners and viewed as contributing the changed value of land as their equity contribution. Time T is the point of construction and lease up completion, when the property enters stabilized operations.

The conventional discounted cash flow (DCF) analysis uses a single blended opportunity cost of capital which assumes a universal risk profile for land acquirement, construction costs, and stabilized operations. Under the canonical form, a different opportunity cost of capital is applied for each distinct portion of the construction process that reflects its risk. This method has the benefit of illustrating the residual land value after accounting for the risk in each phase. Those employing the blending OCC using the DCF may under- or over-estimate the value of the project and choose a financially unwise choice.



Even under the rigor of the Geltner and Miller canonical model, we see that returns in the entitlement phase still remain undocumented. This research was undertaken by Tod McGrath at the MIT Center for Real Estate in which cash flows were estimated for each phase of development including: permitting, construction, lease-up, and stabilization. Developers were then asked what long run IRR premium they would require over stabilized property IRRs in order to enter the project at each of the three pre-stabilization phases. This forced developers to quantify their perceptions of risk for each sub-phase as opposed to their generic full project IRR expectations. This un-blending reveals consistent conclusions of the implied IRRs within each phase.



Source: W.T. McGrath, "Financial Economics and 40B: A Framework to Mediate the Fight Over Money," MIT CRE Working Paper, 2005. Illustrating expected returns for the Permitting, Construction, Lease-up, and Stabilized Operations.

Developers sought an 8.3% return on stabilized operations, a 9.6% return on the lease-up phase and a 17.8% and 37.8% return on construction and permitting respectively. McGrath's paper concluded that the money spent during permitting which included land options and project design ultimately represented 3% of total project costs.

This suggests that perception of risk in the development process is linked to control; where lack of control corresponds to the inability to guarantee political success and ensure returns. The developer begins from a position of minimal control, perhaps having an option on the land. Each successful step in the process increases control and reduces the risk that can derail the process.

Economically, the findings of McGrath and the *canonical model* both support the relationship between cumulative investment and risk as depicted in the Geltner/Miller graph. Research indicates that the highest point of leverage of a local developer when competing with a national investment fund to entitle land are the local connections they may have. Unfortunately, as this

graph indicates, the required capital for this phase is low. Because of this, a national player can easily buy "local knowledge" and presence. Indeed, as community development decisions literally become more public, through the internet and cable access channels, the ability for local players to ensure a sweetheart deal diminish and this perceived advantage for the developer disappears. Again, the advantage lies with the pocketbook.

Chapter 3 - Increasing Entitlement Complexity

Introduction

Over the course of the 20th century, the business of land acquisition and entitlement has become increasingly difficult. The challenges are the result of both political and social realities and include:

- expanding zoning laws that may restrict land use options
- jurisdictional overlap of government agencies that oversee the entitlement process
- regulatory creep that expands land use regulation and limits potential development locations
- increasingly politicized communities

These challenges result in a dwindling sense of control. With increasing government and neighborhood participation in the development process, the ex ante perceived bundle of rights granted under fee simple ownership is diminishing. Making land ownership rights whole again may require negotiation with governments and abutters which may result in linkage concessions. As land use regulation continues to intensify, the loss of control will represent greater and greater risk to land acquisition and entitlement entities. If, as McGrath discovered, the high expected return during the permitting phase is due to the lack of control, then being able to better ameliorate the affects of these issues would diminish the risk.

Zoning Expands

The early 20th century saw the arrival of general zoning codes defining districts and use oriented restrictions. Early noteworthy efforts were in place to demand setbacks at higher elevations of New York skyscrapers to ensure natural light at street level, and the widespread desire to separate industrial uses from residential areas. The interest in development controls was increased in the 1960s with the perspective that not all development was good, and the process was brought into stringent oversight through environmental, traffic, and historic preservation concessions and considerations. The foundation from which municipalities legally structure their zoning codes was derived from the realization of three key considerations:

- certain parcels should remain undeveloped permanently

- when allowed, development should be subject to by case review of impacts and effects by a municipal authority
- permitted development should provide mitigation to compensate for its negative externalities⁹

While any taxpayer or community member can anticipate wanting a stop gap to rampant and insensitive development, the amorphous perception of "how much review" and "how much impact" and "how many negative externalities" make the seemingly rigid zoning code open to interpretation and whim and contribute to the "rise of zoning" as an increasing impediment to development.

Jurisdictional Overlap

Jurisdictions of government have made development increasingly complex over the past century as agency approval may lie at the local, county, state, or federal levels and may overlap one another. The increasing strength and participation of the Environmental Protection Agency, Army Corps of Engineers and the Endangered Species Act may complicate local approvals. Likewise, local authorities may call for more rigorous stipulations than is federally mandated. One study found that 58% of Boston area communities have septic system regulations that exceed state standards.¹⁰

Sometimes these overlapping jurisdictions can exist on a single building. Renovations or redevelopment of properties listed with the National Registry of Historic Places may have handrail heights, stair irregularities, and existing lead paint that may not conform to the national building code. Getting a certificate of occupancy will entail communication between the local code enforcement officer and the federal historic program and will may contribute to project delays.

⁹ The components of this list are culminated from both the above referenced article as well as class presentation made by Gregory P. Bialecki at the MIT Center for Real Estate on October 3, 2006.

¹⁰ Edward Glaeser, Jenny Schuetz and Bryce Ward. "Regulation and the Rise of Housing Prices in Greater Boston: A study based on new data from 187 communities in eastern Massachusetts." Cambridge: Rappaport Institute for Greater Boston, Harvard University and Boston: Pioneer Institute for Public Policy Research. 2006.

At times, the required oversight defies local knowledge. At one development in San Clemente, California, the Army Corps of Engineers required a developer to install three bridges over navigable waters that the developer claimed were runoff streams. Although the developer was not looking to pave over them, it was clear that the waterways could be accommodated with less dramatic efforts. Some consider the Army Corp their "biggest frustration" due to the need to classify waterways and their "regulatory arm twisting for permit approval."¹¹

The surge in prices in the past five years and related increase in construction has led to a sharp increase in entitlement timing. One builder in Florida suggests complicated approval processes have resulted in a tripling of approvals time.¹² Final authority, in many cases, is difficult to identify and may change with changes in political party. The increasing presence of federal interference in the approvals process embodies an exception to the assumption that most entitlement battles are local.

Regulatory Creep

Development pressure on communities has resulted in increasing regulatory hurdles. Studies indicate new restrictions often result from the desire to maintain a desired aesthetic or restrict increased demands on services. In order to achieve these goals, communities are enacting more onerous land use regulation which shuts out growth and development. Zoning, as a living document, may change over time under the radar of many in a community. However, issues of regulatory creep present themselves in a much more dramatic fashion, namely, the social cost of more expensive real estate.

A thorough study titled *Regulation and the Rise of Housing Prices in Greater Boston* conducted by Edward Glaeser, Jenny Schuetz, and Bryce Ward of Harvard University in 2006 revealed dramatic conclusions about the housing market in 187 town surrounding Boston. Fundamentally it was discovered that regulation, not density, has caused the low development pace and corresponding high property prices in Boston over the past 25 years. It was hypothesized that high density areas were likely to resist further development, but the opposite was true. Towns

¹¹ Caulfield, John. "The Long and Winding Road" *Builder*. August, 2006, p172.

¹² *Ibid*, 171.

with less density had established extensive regulatory impediments to development and this has contributed to a dramatic decrease in development activity throughout the MSA. These regulations typically involve:

- restrictions on lot size
- restrictions on lot shape
- growth caps and phasing schedules
- wetlands regulations that exceed state requirements
- septic system regulations that exceed state requirements
- onerous subdivision rules

The regulations reach different extremes in different towns and result in heterogeneous regulations across localities. This has greatly slowed development. Within these communities, there were 172,459 permits issued in the 1960s which slowed to 141,347 permits in the 1980s and 84,105 permits in the 1990s as greater restrictions became commonplace. The researchers suggest that without these hurdles, home prices in Boston would be potentially 23-36% lower, or \$276,100 rather than the 3rd quarter 2005 median price of \$430,900. While the authors do indicate some of this value is derived from the Boston area renaissance attributed to the technology boom, the numbers speak for themselves.¹³

While Boston is but one example, it illustrates how increasing land use regulations can greatly complicate development and stifle progress. While current residents might revel in the perceived spike in house values, eventually, the economy will demand the full range of housing options for every member of the community. The financial implication of generous minimum lot sizes is the prevention of certain socio-economic groups. This can result in regulatory red lining of a town.

¹³ Edward Glaeser, Jenny Schuetz and Bryce Ward. "Regulation and the Rise of Housing Prices in Greater Boston: A study based on new data from 187 communities in eastern Massachusetts." Cambridge: Rappaport Institute for Greater Boston, Harvard University and Boston: Pioneer Institute for Public Policy Research. 2006.

Policy decisions that limit development can backfire when a growing economy demands more housing options.

"One factor that is typically under-appreciated by policy makers is the future signaling effect of current policy decisions; a policy enacted today for a particular situation affects investors' expectations of future policies. Even though the current policy, say a prohibition of development for a particular parcel of land, may be in response to a very specific problem, the fact that they policy maker has obtained the power to enact such a prohibition makes it impossible for the policy maker to credibly commit to not imposing a similar prohibition on some other property in the future--even if the policy maker truly believes (at the time) that such a policy will never be enacted again. As a result, active involvement in the development process injects another source of uncertainty into the mix already facing private investors: regulatory risk."¹⁴

Politicized Community

While regulatory creep illustrates the enforceable policies enacted in a municipality, there is also the active and vocal participation of citizens in ongoing development. Although difficult to quantify, this seems to be an increasing part of the development process. This increased participation may have resulted from the destruction employed in urban renewal and the community backlash over the loss of cherished vistas and farmlands. Often, misguided redevelopment efforts are used as a catalyst for community participation in neighborhood destiny.

In dense metropolitan areas, there is a heavy trend toward protecting the first mover advantage; a situation in the residential sphere that sees residents "closing the door" behind them in order to protect a communal asset from being developed. Even as subsidized externalities, these spaces enjoy self promotion as they contribute to a perceived quality of life. This, in turn, draws more people to a location. The reaction of current residents is to establish barriers to additional in-migration. A recent study revealed: "individuals find it appealing to use their first-mover advantage, relying on the machinery of their local governments to preserve the ambiance of their residential enclaves with surrounding green spaces or prevent aesthetically unappealing commercial development--in a way that shifts the cost of such regulation onto other parties."¹⁵

¹⁴ Turnbull, Geoffrey. "The Investment Incentive Effects of Land Use Regulations" *The Journal of Real Estate Finance and Economics*. Vol.31, No.4, 2005. p361.

¹⁵ *Ibid*, 360.

As real estate assets outlive us, it is appropriate that many individuals participate in its creation. From the developer's perspective, however, the exhaustive list of stakeholders represents potential hurdles to construction and ultimate returns. The final say often lies with the people and those willing to speak up include:

Owners	Bank	Investors
Zoning Board	Code Enforcement	Fire Chief
Community Groups	Historic Commission	Town Council
Housing Authority	Market Competitors	Traffic Authority
Utility Companies	Environmental Action Group	EPA
Endangered Species Advocates	Waterfront Action Groups	Lawyers
Army Corps of Engineers	Neighborhood Groups	Abutters
Lawyers	Title claimants	Landscape Advocates
Unrelated User Groups	Armed Forces (Air Safety)	Trade Unions

The campaigns of these stakeholders have featured increasing sophistication in recent years. One builder notes these campaigns are becoming less about passion and more about facts and figures.¹⁶ Although discussed elsewhere in relation to community outreach, this remains a wild card in the process that can present itself before, during, or after a permit is issued. Patience is required of the developer as he carefully communicates the parameters and benefits of a project to a suspicious audience who are likely to have real and appropriate concerns. However, the hundreds of community meetings required of some of these projects can leave one feeling as though there may be "too many cooks in the kitchen."

These community voices have varying degrees of leverage, and are particularly strong during an election cycle. It is often noted by developers that "the only boss of an elected official is the public. It is that simple."¹⁷ Doug Krahe of Standard Pacific notes that "Almost everything we do is geared around the timing of elections."¹⁸

¹⁶ Caulfield, John. "The Long and Winding Road" *Builder*. August, 2006, p173.

¹⁷ Davies, John and Tynan, John. "Site Development" *Communications* Vol. 31, No. 10, p32.

¹⁸ "New Buzzword in NIMBYland: BANANA: Build Absolutely Nothing Anywhere Near Anything."

Tech savvy constituents can now turn to the internet and the use of blogs to post and discuss ongoing projects. One project experiencing this reality first hand is the Atlantic Yards project in Brooklyn, New York being developed by Forest City Ratner. The New York *Times* notes that about 12 blogs follow the Atlantic Yards project regularly.¹⁹ Commentary ranges from architectural critique to verifying zoning compliance, traffic engineering reports, and the motives of individual Forest City executives. The nature of technology can only grow in complexity and participation in the development process. It gives people access to property information, zoning regulations, sales data, and ownership information in an unprecedented fashion.

Conclusion

Development faces increasing challenges that approach from many angles. Municipal government action leads to regulatory creep, local citizens have leveraged technology and passion to become more active participants, and overlapping regulatory agencies make the process more cumbersome. As development tends to be a public sport, it is unlikely that any of these forces will diminish in the coming years.

These regulatory and political challenges combine with financial and physical challenges to represent risk in the entitlement process. The development entity may gain a competitive advantage through the shortening of the development cycle. Institutional capital is better suited to this challenge for two reasons. First, economies of scale in due diligence and permitting are achieved by the sheer volume of projects reviewed and second, this sheer volume will quickly create best practices suggestions given the location in the country and type of project.

¹⁹ Confessore, Nicholas. "A Blogfest Over a Project in Brooklyn" New York *Times*. April 16, 2006.

Chapter 4 - Strategies and Concerns

Introduction

While the land acquisition and entitlement process has grown more complicated in recent years, there appear to be several mitigating solutions employed by successful developers, large and small. Strategies employed by fellow developers suggest a "developer's toolbox" for easing the entitlement process. While entitlement strategies may enable a smoother permitting process, development entities must also be wary of the tax implications of their business. These tax implications can have significant monetary impact and affect the health and longevity of the business. Finally, developers and landowners alike have more options in specifying land destiny. Where once, only wealthy individuals might bequest property, there are now multiple avenues to retrieve the economic benefit of a land parcel while simultaneously preserving it.

Any discussion of developer strategies must recognize the difference between urban and suburban locations. Returns are sometimes harder to maximize in urban locations. This may be due to the inability to generate economies of scale when compared with large tract suburban housing development. Piecemeal assemblages in cities may take at least as long to get entitled and higher per unit cost for entitlements may affect returns. Additionally, if the developer is changing the character of the area, than they may be improving infrastructure as a primary mover that later benefits competitors. John Westrum, of Fort Washington, PA based Westrum Development Corporation notes, " If you want to change a neighborhood, you need staying power; professionally, financially, and mentally."²⁰

Whereas the past featured the creation of real estate under ad hoc rules, the new paradigm envisions a detailed and deliberate approach to the process. Large developers and REITs rely on this replicable approach, and local developers would do well to emulate. Observation of best practices reveals a "human capital arbitrage" that diminishes risk by way of past experience, flexibility, and capital. Discussions with industry players, published REIT strategy, and local

²⁰ Sperber, Bob. "Thinking of getting into the development game?" *Professional Builder* Vol. 70, No. 8, August 2005. p74.

press articles that evaluate the success of particular builders/developers throughout the country often feature common themes. Here is a summary of widely held "best practices":

Changing Zoning as an Advantage

A protracted entitlement battle may benefit the developer if he seeks a planned unit development or parcel specific zone change. This may result in a first mover advantage by creating barriers to entry for subsequent market players. For example, a supermarket chain may gain entitlements to build in a previously unwelcoming location. If the zone change is considered a poor decision in retrospect, and similar projects will not gain traction in the future, the value of the first project instantly increases.

Alternatively, if a developer proposes an innovative concept and convinces a municipality of its viability, the development will have market uniqueness and a potential competitive advantage. This type of scenario has played out across the country as New Urbanist communities challenge existing zoning to the developer's eventual benefit. For example, the Green Companies in developing Pinehills in Plymouth, Massachusetts lead numerous first person tours to convince voters that reducing road setbacks would improve view corridors and the atmosphere of the entire development. Additionally, the developers convinced town officials to permit extremely narrow roadways, some as narrow as eighteen feet, after comparing the roadways in the development to the town's cherished tree lined and narrow King's Highway, still the oldest continually passable roadway in the United States.²¹ The Green Companies were successful and the results are noteworthy--the roadways are in stark contrast to conventional subdivisions and the project is benefiting from exceptional profitability. The efforts of the Green Company that involved using area history and a vision for a development illustrates that rezoning may be the most informationally intensive entitlement strategy. Tony Green recognizes this and notes that the key to entitlement is "how creative you are in the permitting process."²²

²¹ Tony Green comments. Pinehills site visit on May 18, 2007.

²² Sperber, Bob. "Thinking of getting into the development game?" *Professional Builder* Vol. 70, No. 8, August 2005. p74.

Community Outreach: Early, Often, Always

Community outreach is by far the most frequent strategy employed for successful entitlement campaigns. Critical to this process, naturally, is the need to listen to the suggestions and be flexible in the vision of the finished project. Being tied to a style, store mix, unit type, or architecture will only result in a longer and more expensive fight. Assuming community groups are reasonable, communicating early and often can turn enemies into supporters and supporters into champions.²³ In situations where local sentiment is unreasonably negative, early community outreach can inform the developer to forego the project. Heeding the cues of the time that will be required can quickly translate into better returns on a portfolio of projects.

This was another great success of The Pinehills. The developers brought potential residents to a sit down family style breakfast followed by a focus group activity. The goal of the developers was not simply to explain the parameters of the project, but rather listen to what the potential residents and the community sought. To that end, participants were asked to create picture boards using magazine cut-outs to illustrate their community "ideal." Spouses were separated and each person was asked to present their poster board. The developers learned that their target market considered the exterior appearance of the properties highly important. The most frequently pictured amenity was a screen porch. By listening and taking actual contributions from residents and potential buyers at the planning stage, The Pinehills generated a lot of cooperation and anticipation from townspeople, many of whom initially opposed the project. This required the developers to forfeit some of the emotional ownership of the vision, but the support of the community was a necessary and worthwhile objective.²⁴

Even the most celebrated projects encounter difficulties. Again at Pinehills, the developers had all permits in place save a final wastewater permit. As permitted by law, a single neighbor initiated legal proceedings to challenge the permits and was successful at holding the project up for two years. Tony Green of the Pinehills indicated that he felt the momentum of the project and community buy-in aided the firm in overcoming the lawsuit. Many firms, such as the national homebuilder Standard Pacific, factor a 100% time cushion on their anticipated entitlement timing,

²³ Tony Green comments. Pinehills site visit on May 18, 2007.

²⁴ *Ibid.*

based largely on anticipated community activism. Anything short of that would be considered a bonus.²⁵

In Seattle, Security Properties Inc. planned to construct an apartment complex in the Fremont neighborhood on a site that had been used for a cherished farmers market for many years. Anticipating neighborhood objections, the firm hired a respected community leader as a liaison at project outset. In addition, the firm organized a local advisory committee composed of leaders from other major neighborhood groups. Being the initiator of the group enabled the developer to set some ground rules, the most important of which was that committee members could not oppose existing zoning, including heights and uses. The resulting project involved significant community participation and reflected the quirkiness of the area.²⁶

Use a Roll Up Note During the Entitlement Phase

The Green Companies structured a roll up note when negotiating the entitlement process for Pinehills. In this structure, interest on all up-front monies necessary for due diligence and entitlement gets rolled into the principal loan. This results in there being no out of pocket payment until it's time to pay the note. This structure creates the potential for deep pockets if necessary and relieves the development entity from day to day financing worries.

Brand Awareness and Reputation

Developers suggest this is a critical element of getting community buy-in and makes subsequent projects easier (assuming the first was completed appropriately). Also, creating a brand and image associated with the development company ensures a stream of "quiet deals" coming through the door, or the privilege of being included in an invitational short list for projects.

Reputation can be enhanced in several ways. There is no substitute, of course, for a successful and well loved past project. But a ubiquitous comment from many projects is the need *to listen*. This appears over and over in newspaper clippings about local feelings concerning a project where

²⁵ Sperber, Bob. "Thinking of getting into the development game?" *Professional Builder* Vol. 70, No. 8, August 2005. p74.

²⁶ "Knock, knock, knocking on NIMBYists doors: community outreach is key to overcoming opposition to new M-H developments." Editor, Multi-Housing News. VNU Business Media Vol. 39, No. 6, June 2004.

a local stakeholder states 'I feel better about it, I can tell they listened.' A second method to enhance reputation is to use the media. The developer is reminded to always 'take the high road' and promote a simple message. Media opportunities such as interviews should be used to promote the ways the project will benefit the community, not about the specifics of the project.²⁷ Recognize that in interview situations, the media will typically focus on public benefits and stakeholder objections.

Know a Municipality's Limits and Capabilities

Staffing of planning departments in municipalities, while knowledgeable, may be overwhelmed and inexperienced. One developer notes the planning department of one major US city had a staff of six with the oldest employee being 25 and only three staff members with experience beyond six months.²⁸ Although extreme, it illustrates the need to recognize that sometimes delays and confusing requirements may stem from inexperience as much as conventional bureaucratic red tape. As city employees get drawn away from these positions into the private sector with some regularity, the knowledgeable developer will accept this as a fact of life and plan accordingly.

Joint Venture with Local Player

Large national developers or investment entities are often cast as "outsiders" by locals. This sentiment can be alleviated by enlisting the help of a local, respected joint venture partner. Firms note that partner selection is a human capital decision and will value their political connections as much as their prior development experience. The local developer would do well to get politically active and participate on planning boards, zoning board or appeals, or as a selectman.

This strategy is important due to the time value of money. Knowledge of the local electorate can substantially aid the strategy for getting a project approved. A development firm that lacks this local touch may be more likely to encounter excessive linkage requirements. A project undertaken by SouthStar Development Partners in Jacksonville, Florida entailed a \$40 million

²⁷ Ryan, Ken. "The Entitlement Process: Ten Tips for Approval" *Multi-Housing News*. Vol. 42, No. 5, May, 2007. p50.

²⁸ Caulfield, John. "The Long and Winding Road" *Builder*. August, 2006, p176.

off site road improvement linkage fee and the requirement to build a regional elementary school that would serve students from an unrelated jurisdiction.²⁹

Purchase Constrained Land

Jim Wait of TransWest, Inc. from Southern California sees a benefit to protracted entitlement process. TransWest considers purchasing waterfront land to be a hedge against a drawn out political process. In their experience, coastal land has consistently brought a 20% yearly value inflation. In their words: "If a governmental agency holds us up for six months, they end up making us a bunch of money in an inflationary time." It is noted, however, that this requires deep pockets and must have a few profit making ventures concurrently being developed.³⁰

Advocacy Outreach

In many situations, community members simply so not want to see a change. In these situations, the developer should recognize that the approvals process may come down to a single vote. Therefore, the best strategy is to sway enough votes to ensure approval. This can be accomplished through phone canvassing, direct mail, or advertising. As one public relations strategist suggests: "You do not need overwhelming support, but you do need the evidence of more supporters than opponents at the hearings. Cynically, it may mean whoever has more bodies at City Hall when it comes to a vote may prevail."³¹

Have a Local Attorney

Perspective on the entitlement process can also be provided by local attorneys. These individuals are likely to have contacts and exposure to past successes and failures within a community. Greg Bialecki, of DLA Piper provides a succinct overview of some of the techniques that seem most adept at getting projects entitled. He is based in Boston, Massachusetts.

- Prepare and present complete permit applications for all governmental authorities
- Ensure certainty of proposal with little or no room for interpretation and discretion for the municipality in granting permits and approvals.

²⁹ Sperber, Bob. "Thinking of getting into the development game?" *Professional Builder* Vol. 70, No. 8, August 2005. p74.

³⁰ *Ibid*, 78.

³¹ "Knock, knock, knocking on NIMBYists doors: community outreach is key to overcoming opposition to new M-H developments." Editor, Multi-Housing News. VNU Business Media Vol. 39, No. 6, June 2004.

- Expect that mitigation will be required of any substantial project. The savvy developer will address this mitigation upfront with a proposal that includes recognition of practical feasibility, financial feasibility, and a proportionate mitigation to the size of the project and proposed phasing.
- Good entitlements will provide flexibility in the commencement of construction
- Good entitlements will provide flexibility in the project phasing. Splitting the project into independent parcels for regulatory compliance may provide insulation from unseen delays when one aspect or phase undermines the overall schedule.
- If possible, seek flexibility in use. Many zoning provisions will not allow this, but with the correct mix of mitigants, a municipality may permit change of use which can be used to mitigate market risk.
- If possible, seek permits that allow for extensions that do not result in a complete renewal or re-application process.
- Regulatory change can completely undermine a development. Permits should be sought that are insulated from future regulatory change through an inapplicability clause.
- Permits should be transferable and "run with the land."
- Finally, there should be a clear procedure to obtain certifications within the permits, thereby ensuring communication is clear regarding how the municipality warrants the conclusion of the project.³²

One Counterpoint

A potentially unfortunate outcome to anticipated lengthy entitlement battles is the failure to innovate. Developers seeking to minimize delays will likely propose as-of-right developments. This may be particularly acute in relation to large funds where entitlement costs are expected to be higher making as-of-right proposals more appealing. Since many communities are unlikely to radically change zoning and planning parameters, development continues in a historical pattern. The citizens of suburban towns that feature excessive lot sizes will demand the repetition of this pattern unless a developer or the government chooses to mount an unpopular policy change, a conclusion of the work of Glaeser, *et al*, during their investigation into Massachusetts land use

³² List provided as lecture handout by Gregory P. Bialecki at the MIT Center for Real Estate on October 3, 2006.

patterns. As sustainability becomes an ever increasing global concern, it will be interesting to witness whether changes in planning attitudes are driven by municipalities or developers.

Tax Implications

Beyond entitlement strategies, another method of preservation for the developer is to ensure their tax structure exposes them to the minimal tax liability. The goal of development entities is to avoid dealer status, which is a differentiation made between being a passive investor and someone who engages in entitlement and development to generate sales. Simply put, being classified as a dealer will result in approximately two times the tax liability than being an investor.³³

This has become an increasing concern in recent years for two reasons. One, developers increasingly option properties that result in "just-in-time" delivery of buildable lots. Two, recent gains in real estate has brought in investors/developers who had previously not participated in this industry. The short cycle of purchase, improve, and sell in the ordinary course of business places them in dealer territory. Most real estate investors have no intention to participate in vertical development, however, participating too much in the life cycle in order to realize maximum gains results in the potential for increased IRS scrutiny.

Entities that seek to entitle and then flip property, capturing the most profit-laden fruit on the vine must be wary of this distinction. The desire to flip and make profit easily preempts the need to consult an attorney and structure the entity in a beneficial manner. "Raw land investing has become almost as sophisticated as 'going public' in the corporate world. The upside is that the numbers are larger, but so is the incentive for the IRS to challenge the 'investor's status.'³⁴

The differentiation stems from profits and losses from ordinary business operation and the profits gained from the accrual of value over time. Supreme Court case law that defined dealer status occurred in the late 1960s and early 1970s. These rulings have been tweaked since then, particularly as a result the real estate valley of the early 90's. The case law was established when

³³ Feldman, Ira. "Plan Now to Avoid Dealer Status for 'Investment' Real Estate" *Practical Tax Strategies* November, 2005, p278.

³⁴ *Ibid*, 279.

most jurisdictions permitted piecemeal subdivision and "lot improvement" was defined by physical improvements, not just paper improvements for flipping parcels. Regulations are now more rigorous and complex and often require property owners to undergo specific plans and entitlement processes to subdivide and develop lots. Additionally, as landowners increasingly participate in the entitlement process alongside the developer through options, the IRS has had success in reclassifying the investment intent of the landowner from investor to dealer.

The threads of intent are slowly getting stitched together as additional court cases make the parameters clear. Now, it is generally understood that the owner's intent can be categorized using eight attributes that resulted from the Fraley case in the late 1970s. Although no single attribute necessitates classification as a dealer, the combination of attributes combine to various degrees to educate the court system as to the intent of the original landowner and developer. The relevant attributes are:

- The purpose for which the property was acquired.
- The purpose for which the property was held.
- The extent of improvements made to the property.
- The frequency of sales.
- The nature and substantiality of the transactions.
- The nature and extent of the taxpayer's dealings in similar property.
- The extent of advertising to promote sales.
- Whether the property was listed for sale either directly or through brokers.^{35 36}

The investor/dealer dynamic becomes more relevant during a heated market as many long held parcels are pressured to be "cashed-in." It can be assumed that the intricacies of investor/dealer status is likely to be lost on most casual investors, especially since programming an entity to avoid dealer status is best done at the outset of asset purchase. Perhaps this is one element of the entitlement picture that represents an advantage to more institutional investor. If entitling and flipping land is the business model, then they would certainly have significant exposure to this

³⁵ *Ibid*, 280.

³⁶ The components of this list are culminated from both the above referenced article as well as class presentation made by Gregory P. Bialecki at the MIT Center for Real Estate on October 3, 2006.

pitfall and be prepared to offer property owners solutions with more first hand experience than a local player. Avoiding dealer status is easily accomplished by parceling the project and separating the entitlement entity from the land sales through the use of LLCs.

Owner Tools

During the 20th century, the landowner, too, gained increasing power to specify the destiny of land parcels. Options involve the ability to reduce, restrict, or stop development from taking place on their parcel. These options mitigate some of the lost economic benefit of donation while preserving natural or sentimental settings and providing a stopgap to land loss. Jim Wyerman, communications director with the Land Trust Alliance notes, "there is a sense of that urgency, that we are generally losing land quickly."³⁷ These tools have further complicated development in recent years.

Conservation Easement

This is a flexible encumbrance that maintains ownership and demands the land remain in the owner desired state as long as specified. The restrictions become part of the property deed and are binding for all future parcel owners. Owners can specify uses that are allowed, are not allowed, and even carve out portions for a restricted use or future development. The property can be willed or sold to an unrelated party. Tax benefits of conservation easements can be substantial and may include property or estate tax reduction.

Conservation easements do not necessarily reduce value. In several examples, non-profits have purchased land and added conservation restrictions. The newly encumbered parcel is then sold to wealthy buyers. Tracts in Vermont and Missouri that were owned by the Nature Conservancy have sold at a profit to buyers who may use the property for a second home. "The conservation easements don't reduce the value at all, because [a wealthy buyer] isn't put off by that type of restriction. They want to be alone, and they're coming to somewhere like Vermont for the isolation."³⁸

³⁷ Kulantzick, Joshua. "Green Acres" *Arrive* July/August 2007, p29.

³⁸ *Ibid*, 33.

Fee Simple Gifts

Much of the protected land in this country has resulted from the generous donation to a conservation entity or municipal government. The landowner earmarks the property for a given use and the receiving entity is obligated to maintain the land under these restrictions in perpetuity. The donating individual receives tax benefits. Under current tax law, the donor is permitted a 30% deduction to their taxable income each year for five years. (BuzzardsBay.org). Furthermore, donors receive property and estate tax benefits.

Gifts of Remainder

Similar to a fee simple gift, a landowner can donate land with remainder interest. Under this arrangement, the donor may remain on the property, under agreements of maintenance and management, until death. The donor, again, receives income tax and property tax benefits, and may play an active role in determining the future use and governance of the property.

Bequests

A landowner can make a bequest of land to an organization within their will. Doing so is similar to a fee simple donation, except the organization typically has the jurisdiction of deciding how to employ the property. The value of the property can be deducted from taxable assets upon the death of the donator.

Limited Development

Those that seek to preserve natural or scenic beauty, but cannot afford donation can turn to limited development. In this case, the landowner and a cooperative developer create some level of development that preserves through deed restrictions, and likely leverages the externalities, of open space in perpetuity. Ownership and management of the open space can be handled by a third party or through covenants on the resulting development.

Purchase at Fair Market Value

The increasingly scarcity of open land and competition between municipalities, conservation groups, and developers has led to a "race notice" mentality for land. Some property owners, either through realities of capitalism or inability to make economic concessions, are willing to

sell for fair market value. Under this reality, many conservation groups and municipalities frequently allocate scarce resources for the outright purchase of land at fair market value. Increasing collaboration between regional conservation groups has resulted in pooling of donations earmarked for land purchases.

Bargain Sale

A landowner may sell a parcel to a conservation oriented organization below market value. Doing so will meet the unified goals of both parties, and allow the seller tax benefits. Under typical circumstances, parcels donated for conservation at below market value will result in tax benefits that are as if the property was transferred at fair market value.

There is a distinction that needs to be made between the bargain sale transfer of a property and the bargain sale transfer of development rights. The Ney case in Delaware resulted in a decision that charitable tax benefits did not accrue to the seller of development rights. In this case, the seller sold development rights to the Delaware Agricultural Lands Preservation Foundation. Under the agreement with DALPF, the seller would retain title to the land, but agreed to use it solely for agricultural purposes. The properties were appraised at the time of the development rights transfer and the seller deducted the difference between the market value and the below market value sale price from his tax liability. The taxpayers failed to properly notify the IRS of the appraised values and submit proper paperwork to endorse the values. Furthermore, the owner failed to meet stringent time parameters necessitated in these instances. Because of these failing, the IRS denied the tax reduction and found the seller did not qualify for the charitable contribution.

Chapter 5 - Entitlement Entities

Introduction

The interplay between local knowledge and access to capital ensures that entitlement risk is viewed differently by different market players. Investors may be opportunity funds, foreign investors, REITs, and wealthy individuals. While some firms may stick closely to as-of-right development as a way of mitigating risk, others strike out in innovative approaches that may eventually require lengthy entitlement campaigns. Still others engage in entitlement solely as joint venture partners, relying on local players to provide the local knowledge and contacts to get projects pushed through regulatory hurdles. Although entitlement is a high risk process, there are multiple organizational structures and firm strategies that are used to meet self imposed or investor mandated risk and return parameters. These organizational structures and strategies appear to be used as a means of overcoming weaknesses and more confidently anticipate returns.

The firms profiled below illustrate differences in entitlement focused entities. They range from small to large and from a firm actively engaged in selling entitled parcels to those that serve merely as financial partners. These firms work in residential, commercial, retail, mixed use, and the industrial sectors. The firms fall into the following categories:

- Private Equity Developer - Land Equity Partners
- Public/Private Equity Fund Generator/Flipper - Dunmore Capital
- Public/Private Equity Fund Generator - Hearthstone
- Public REIT - AvalonBay Communities
- Public/Private Equity Investor - Heitman

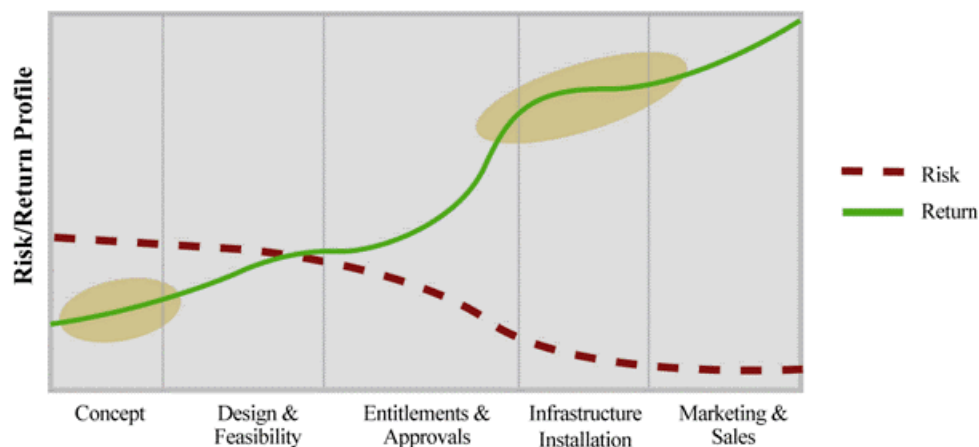
The returns that each of these entities expect from entitlement investment are consistent. Quoted goals are in the 20-30% range with many experiencing additional returns from engaging in joint ventures. In these circumstances, profits beyond a return hurdle rate greatly enhance their total return.

Land Equity Partners³⁹

Description

Land Equity Partners is both a private real estate development company and investment fund based in Park City, Utah. The firm turns raw land into residential and commercial lots through the entitlement process. By seeking land opportunities that offer exceptional value creation in the early land development process the firm generates favorable returns. Over the past 35 years, this firm has been responsible for 75,000 residential lots in the US and Mexico.

The firm applies proceeds from their entitlement funds to secure various finance positions in desired projects. These include equity interests, secured, unsecured and convertible debt, direct land purchase, and land takedowns in stages. The investment mentality of this firm recognizes the relationship of cumulative investment as an inverse to success probability per Geltner/Miller as outlined above. By their own admission, LEP attempts to enter the deal during the conceptual phase and exiting immediately upon infrastructure installation. The below graph illustrates this strategy.⁴⁰



Organization

As a firm, Land Equity Partners features a collection of partners that offer extensive and broad experience. One is left with the impression that the mix of skills ultimately provides redundancies that produces a great level of investor confidence. The firm partners bring skills in

³⁹ Commentary generated from phone interview conducted with Bill Coleman, President, Land Equity Partners on May 7, 2007.

⁴⁰ www.landequitypartners.com

architecture, brokerage, accounting, construction, civil engineering, and public relations/strategy. LEP seeks to move swiftly through fund raising, land locating, entitlement, and disposition.

Their project review does not undergo traditional investment committee review. While the firm partners do congregate to review and make investment decisions, LEP has had success generating sophisticated Excel models that incorporate time and entitlement delay probability. These models are tailored for land only and incorporate tens of projects in various locations in incremental positions in the development process. Projects pursued for investments are evaluated both as a stand alone opportunity as well as its impact on the existing portfolio; all of which do not provide cash flow.

The process of "finding dirt" at LEP has evolved over time. Originally, the firm partners came together on account of their symbiotic skill set. Because of this, initial deals were found using a "scratch and sniff" mentality that relied entirely on existing relationships and word of mouth. After establishing the initial entitlement fund, however, the firm turned toward more conventional methods, such as the use of brokers and civil engineers, due primarily to the need to gain quick information on unknown territories and introduce a level of accountability to the process.

While they continue to conduct market research in-house, they now turn to consultants for background information. These consultants, such as MetroStudy, are consulted less for market data commentary, and more for data related to builders and the problems builders have faced in a particular location. This obviously creates a surrogate "local knowledge" base from which LEP can enter into their entitlement strategies. The focus on builder assessment separates LEP from its competitors who appear to seek out third party consultation that focuses more on market conditions.

Geography

LEP has blossomed outside of Utah to encompass many of the western states in the US. Large scale projects have been completed in Colorado, Montana, Idaho, California, and Arizona. They

have also completed projects as far east as Vermont and Quebec and south to Baja California in Mexico.

Strategy

The strategy of Land Equity Partners is to generate small equity funds in the \$20-30 million range that are used to entitle greenfield residential development and limited commercial development. The firm recognizes three liquidity moments that all offer a point of divestment.

These are:

- when the property is optioned
- when the entitlement process is completed
- when the infrastructure is completed

Without exception, LEP will not undertake vertical development, and will typically only produce infrastructure in markets without large merchant builders, such as Bozeman, Montana. The best scenario has them selling a platted land parcel as a wholesale package to a merchant builder. In some cases they will sell individual lots to small local builders, or they will sell the entire project to a third party developer who may add additional development prior to selling to a merchant builder.

LEP maintains an absolute recognition of the time value of money. Unlike some of the other subject companies that sought speedy entitlement but recognized that it wasn't always a possibility, LEP allows time to be the primary driver of project selection. This may be different than some of the other subject companies because the others are in markets (California) where land constraints may be greater and they accept the timing element as an unavoidable hurdle. LEP, on the other hand, seeks projects that are greenfield sites where tying up the land is not uniquely difficult and they may have several possibilities to choose from. They have the luxury of choosing which municipality to battle with.

The perspective of LEP is that their strongest ally in the entitlement process is the local engineering company who has connections with elected officials and can provide site context

and data. The firm also uses the same land planner for all projects who takes topographical and geologic data from the local engineer and produces plans quickly.

A suitable case study suggested by company President, Bill Coleman, is the Targhee Hill Estates in Driggs, Idaho at the Grand Targhee resort. This project featured all the pitfalls and nightmares possible in an entitlement process. Strangely enough, the process started with a favorable assemblage process where the initial land purchase led to two abutting farmers to offer portions of their own plots. From this fortuitous start, the project immediately faced serious hurdles. There was an unexpected development moratorium imposed followed by water system issues, power line right of way issues, market issues, density issues, and a major water rights battle which involved site clean up and liability. There was an element of "exponential complexity" due the fact that the site also straddled state lines. Due diligence revealed many of the potential issues, but still did not prepare LEP for the rigorous process of dealing with all the stakeholders involved. This was a project that clearly benefited from LEP's diverse set of skills under one roof. Land solutions came into focus thanks to clever civil engineering, the product type became clear due to architectural skill, and abutter appeals were diminished thanks to the efforts of one firm partner who enjoys the process of "getting soccer moms who initially oppose a project to eventually eat out of [his] hand."

Terms of JV Deals

The entitlement fund system that is used by Land Equity Partners involves forming a partnership entity between general partners and equity partners. Typically, about 50 equity partners contribute 50% of necessary capital with Land Equity Partners contributing the remaining 50% as general partner. When serving as general partner, LEP is responsible for sourcing and pipelining development projects to ensure anticipated returns and serves as the "local" participant. LEP's high level of equity participation necessitates exceptional project valuation and separates them from others discussed below. While many general partners will roll in fees or provide a low percentage contribution, LEP is fully represented in both equity and management. In other projects, LEP may serve as a general partner only. LEP, like others, is paid a developer fee which is considered part of their return. They may serve as both general and equity participant in their "conventional" projects, such as extensive greenfield residential development in Montana,

but serve as equity partners in exploratory geographies and product types, such as the second home project done in Baja California, Mexico. Each deal is treated as a separate LLC entity. LEP is currently entitling with equity raised in their third fund.

Returns

LEP recognizes that conversion of raw land to an entitled parcel can easily raise the value 100%. With fund management and deal sourcing accounted for, initial LEP pro-formas often target a 60-70% return. LEP credits its lean workforce with an exceptional re-sale strategy. Coleman indicates that their limited staff and strategic skills enable them to get a parcel entitled efficiently. When the firm sells the parcel they can leave some of the return for the subsequent owner. This embedded return, usually targeted at 20%, allows the firm to undersell competitors and provide purchasing merchant builders with a silver platter situation. LEP ensures their portfolio return, and in accordance with their time heeding mandate, they sell at a discount to a lucky builder. After accounting for the embedded profit, their first fund returned a 32% IRR. The first two funds were each applied towards four projects each.

Dunmore Capital⁴¹

Description

Dunmore Capital is an investment manager generating funds for the entitlement of raw land. Equity sought is both public and private and the entitlement process is executed largely in-house. Their first and current fund, the Dunmore Fund I, is seeking \$500 million.

Perspective on Dunmore's perspective on risk in the entitlement process was provided by John Hartman, the company President. This firm considers entitlement only funds a new asset class for institutional money and one that is becoming increasingly commonplace. Hartman has a long history in managing institutional money in the residential development field. He notes that in the late 1980s and early 1990s, the finance world considered the value split to be 50% in the land entitlement, and 50% in the "sticks and bricks." The dramatic development of the REIT industry and the creation of more sophisticated investment vehicles led to the contention that entitlements now represent 80% of the value.

Geography

Dunmore is based in Sacramento, California and has typically focused on communities within the central core of California. Hartman notes the fundamental lack of residential developable land in this region. In fact, they conduct business in communities that often have no remaining R-1 zoning, and therefore every aspect of their business revolves around the successful re-zoning and entitlement of parcels. This seems to support the hypothesis that those entities that are forced to consistently endure re-zoning efforts, the toughest entitlement, would benefit from a locally focused approach.

Organization

Dunmore Capital is a spin off of Dunmore Communities which has a long standing history in California. This history, in fact, is what the company considers a key competitive advantage. The image of this brand as a trustworthy community partner is clearly used as leverage as they attempt to break into new communities, or invest to a greater extent in familiar territory. The

⁴¹ Commentary generated from phone interview conducted with John Hartman, President, Dunmore Capital on June 26, 2007.

fund proceeds generated by Dunmore Capital are funneled primarily into Dunmore Communities projects, although about 10% is used to invest in outside projects using a joint venture structure. These JV deals are always within their target markets and are often executed with established national firms, such as Trammel Crow.

In addition to fund managers and fund raisers, Dunmore Capital has a full time entitlement staff. These are individuals that are sourcing and shepherding deals through the entitlement process. Dunmore differentiates itself with its self sufficiency and tendency to not rely heavily on outside consultants. Strategically, the entitlement team is composed mainly of former city and county planners that have existing relationships with planners in target communities. These individuals are able to speak the political language necessary to move the process forward.

Mike Winn, of competing firm Reynen & Bardis of Sacramento echoes this strategy. His firm approaches the entitlement process with seven full time in-house staff including a wildlife biologist. He relies on expertise of the staff and the connections with city planners they bring from their previous positions to ensure that approvals move forward. Winn feels a full time entitlement staff is critical to their success. "...in California, if you try to do entitlements part time, you're going to get smoked."⁴² Even with the entitlement staff, the intensity of California entitlements may be best illustrated by the fact that Reynen & Bardis assumes a *seven year* entitlement process from concept to finish grading of infrastructure.⁴³

The firm avoids dealer status on their sales by platting the projects at the corporate level and then selling lots at the LLC level. Also, in a typical project, the firm will break off the residential component for sale to merchant or dominant local builders, and save the multi-unit/commercial/retail component for themselves. By holding back this element of the project, they are able to wait for the merchant builder to build out the community before entering into commercial or retail leases. This gives them greater leverage when negotiating leases because potential tenants have a captive and defined market.

⁴² "It's not NIMBY anymore--it's BANANA" Don Markley. *Broadcast Engineering*. Vol.44, No.3, March, 2002.

⁴³ Caulfield, John. "The Long and Winding Road" *Builder*. August, 2006, p171.

In some instances, the apartment or retail entities will participate with Dunmore at the outset. Although they will not accept entitlement risk, they will pre-lease locations, providing the privilege of participating in the design and scope of their completed storefronts. Dunmore is able to extract a premium for this.

The fund is generated primarily through institutional investors. However, the relatively low \$5 million fund buy-in means the fund is necessarily co-mingled. This is often a concern for large pension funds that like to be the dominant fund investors. However, even with the co-mingled nature, Dunmore Capital has managed to attract large pension funds, including the California State Teachers' Retirement System (CalSTRS). The primary private investor profile is overseas investors interested in the California market. The softening real estate market in California since 2006 has actually resulted in increased interest by contrarian investors.

Strategy

The risk in entitlements, according to Dunmore Capital, is almost entirely political risk. As almost all their deals involve a re-zoning process, the firm is anxious to participate on a local level. To do so, they participate in the creation of general plan amendments. According to Hartman, they take a humble, backwards approach. Many developers approach municipalities with a sketched project in mind. They might approach the town looking to place, say, 30 houses on 12 acres with 20,000 SF of commercial space. That strategy, Hartman contends, often places the developer at odds with elected officials and local citizens. There is little negotiation and limited local involvement.

The Dunmore approach attempts to back into the project. They will enlist the help of the political forces in the town by offering to build 30 houses on 12 acres with 20,000 SF of commercial space somewhere within the town limits. They ask the town authorities where they would like to see the development, and if the development can be used as a catalyst for a direction of growth the town is attempting to support. Or, they may ask where the town imagines the infrastructure can now, or can soon support a development of this size. Typically, a town with a long term growth strategy will have a plan in place that meshes well with this strategy. The town may enlist Dunmore to participate in the infrastructure improvements, which they do. The result of this

approach is a tacit approval of the development at the outset from the municipality. Having the support of elected officials greatly eases the second phase of the process which is literally pulling out a map and knocking door to door.

Dunmore further mitigates political risk by rigorous research. The scope of their due diligence process spreads far beyond parcel specific factors, and looks closely at the individuals who will be making policy decisions about the project. This involves the general political stability in the community, the length the politicians have been seated, and if there is a strong or growing environmental movement in the community. Hartman notes that pro-growth areas can make an about face in one election cycle which may undermine a project in the middle of its approvals. Although it is nothing more than a gut estimation, a long seated politician in support of a project can be factored into the probability of approvals from a risk mitigating perspective.

The firm is now considering broadening their scope beyond California to alternate markets such as Oregon, Washington, Connecticut, and Florida. Comfort in the entitlement atmosphere in new areas is gained by exhaustive research. For example, the firm recently investigated the possibility of entering the Colorado market. After research and site visits, it was determined that the regulatory process there may be *too* relaxed to generate the needed barriers to entry necessary to ensure real profit. In many instances, they found approved plat maps sitting unsold leaving them with the impression that if you bought or controlled the land, you could get a project approved. Subsequently selling this approved project presented the greater risk.

Although Dunmore, like many entitlement firms, seeks to thread the needle of a reasonable entitlement process for themselves while creating barrier to entry for others. Hartman suggests they have frequently achieved this through focusing on secondary markets. For example, while they have recently run reconnaissance on Oregon, the firm avoided Portland in favor of Eugene, or suburbs of Eugene which was similar in growth projections but has lower perceived regulatory hurdles.

Their market research strategy is simple and defined. Beyond the political spectrum discussed above, the firm investigates absorption of sales, the number of maps in process, identifies strong

local partners, and determines the dominant product type. The last point is particularly important to them. Quite simply, they seek what product type is selling fastest and seek approvals that mimic this development. They seek lot development that best fits the expectations of the end buyers. Doing so permits them to work backwards by estimating the merchant builders likely costs thereby leaving them a speculative paper plat cost. This process has been repeated with great success over many communities.

The fundamental strategy of Dunmore Capital is consistency in understood markets. This is a firm that keeps a vigilant eye on all the development currents in their target communities. They track absolutely all general plans proposed, maintain close relationships with regional appraisers, and conduct constant market research. Like many areas, much of the remaining developable land in California is farmland that is likely to have been in families for generations. Of course, family land has its own pitfalls, which seem exponential as ownership splits many times with each successive generation.

The strategy for acquiring these parcels is simply to create honest relationships, which is accomplished, quite simply, with "boots in the dirt." Dunmore Capital seeks coffee and pie at the kitchen table moments with landowners who "don't know they want to sell their land until we knock on their doors." In many cases, California is a highly researched marketplace, and many of the generational landowners receive unsolicited development offers in the mail. Dunmore embodies a strategy that moves away from adding to the stack of FedEx packages on the kitchen counter. In one example, Hartman explains an interaction where the landowners was not opposed to selling, but couldn't imagine starting over in an unfamiliar location. They often receive comments like: "I go to that Post Office, and that grocery store. I don't want to move." In some of these instances, Dunmore was able to generate a win-win situation where the landowner gets a carved out parcel of a few acres. This created the situation where the landowner maintained ownership in the familiar setting, benefited from the land sale, and Dunmore was able to profitably develop the remaining acreage. These negotiations and unconventional solutions are missing from the stack of FedEx packages, even though the solution is not revolutionary. Objections from landowners are often more about convenience than price. Dunmore Capital is a firm that recognizes this to their advantage and seeks to reduce the anxiety of the landowner

through a personal connection. In the words of Jonathan Hartman: "land entitlement is truly an art form."

Terms of JV Deals

When Dunmore Capital partners with firms other than Dunmore Communities, they expect the JV partner to conduct the entitlement process. In these situations, Dunmore reserves their in-house entitlement team for times of acute need, when the process falters, and the team can ensure a positive outcome. Although not explicit in our conversation, perhaps this is a strategy used to prevent overexposure of the Dunmore name to repeated political battles.

Returns

The returns in entitlement funds are derived fundamentally from the purchase price of the parcel. The goal of any of these funds is to purchase land as close to agricultural value as possible. Doing so is the best way to ensure dramatic returns. The company projects the entitlement process to take 18-24 months which they have a high confidence in due to their defined market and in-house entitlement team. The firm has had great success in the past with the overall IRR over the past 20 projects sitting at 46.6%. They expect a 3 to 6 time return on their capital. Working from this foundation, the firm greatly increases returns using leverage.

Hearthstone⁴⁴

Description

Hearthstone is an investment manager that places institutional capital into residential real estate. In the past, this has included various levels of involvement in projects. But in 2006, Hearthstone announced their Path of Growth fund which was a projected \$150 million fund to be used to find and permit non-entitled projects throughout the western United States. They quickly generated \$1 billion in equity and are now spending \$500 million per year. Although they are similar to a real estate opportunity fund run by Lehman Brothers or Morgan Stanley, Hearthstone is the largest pure play entitlement firm in the United States, and likely the world. Unlike other firms discussed here, the Hearthstone Path of Growth fund is composed entirely of institutional capital. The company is located in San Francisco, California. Perspective on Hearthstone was provided by the company President, Jeff Barcy.

Hearthstone was founded on the principle that they could provide a stable source of capital for homebuilders experiencing difficulty getting project financing during residential market downturns. In exchange for a formalized relationship, builders can acquire project financing that is non-recourse, scalable, available quickly, and up to 100% of project costs. The builder relationship strategy involves pre approving builders under a company rubric. Communication is encouraged both ways with Hearthstone sourcing potential opportunities and builders bringing projects to Hearthstone. The more lenient lending parameters and the potential for a deep pocketed equity partner is appealing to builders and has created a competitive advantage for Hearthstone.

Another critical element of the Hearthstone structure is that at the outset of the Path of Growth fund, the firm brought in Albert Praw, a former homebuilder executive with KB Home. Praw is respected for his broad knowledge of the country and the business. He is able to react very quickly to opportunities because "he knows every pocket of the country and can easily identify key roads, etc. that will make or break a project." In this sense, Hearthstone has reduced its risk even at the "back of the envelope" level. Barcy and Praw have divided the deal sourcing labor

⁴⁴ Commentary generated from phone interview conducted with Jeff Barcy, President, Hearthstone on June 19, 2007.

according to their strengths with Barcy taking leads from developers and potential operating partners and Praw answering the call from farmers and brokers.

Organization

As an investment manager, the role of this company is primarily equity sourcing and financial due diligence. Barcy indicated that his group's long experience and many existing relationships drive a lot of unsolicited business. The principals of the fund are always looking for builders and deals. Typically, the builders the firm works with are large regional players or national merchant builders who can handle projects that would benefit from a slice of \$500 million.

An Operating Partnership is used to tie up the land and commence a partnership between Hearthstone and the merchant builder. The builder manages the entitlement process while Hearthstone continues to verify market assumptions and financial viability. Once permits are in place, a joint venture agreement is made between the parties that enables the commencement of construction.

Geography

This firm is based in California and makes significant investment there. Due to its fund size, it is working on branching out into other parts of the country.

Strategy

Hearthstone has a distinct strategy that was clear in speaking with a company principal as well as identified on their website. There are five main tenets that include:

- Focus on residential development exclusively. Their only business is managing institutional capital in the residential market.
- Develop and maintain strong relationships with quality builders. These partner firms should be dominant market players. The expectation is that this focus on relationships and repeat transactions contribute to reducing risk for their investors.
- Diversify. Just like a stock portfolio, Hearthstone is sure to diversify its investments in many markets. The benchmark goal is 50 projects a year. Diversification is sought by

geographic region, builder, and product type (but still residential). This fund tends to cap individual investments at \$30 million.

- Co-invest. Hearthstone requires every member of its investment committee to co-invest alongside the institutional investors to ensure alignment of goals. While this was a frequent comment among the entitlement funds that were consulted, the requirement to invest personal capital (versus "investing" yearly bonuses or potential income) was different.
- Research. This firm has an in-house research staff that tracks markets of interest and it considers this knowledge to represent a competitive advantage.⁴⁵

Although there is considerable capital to be placed, Barcy considers himself a conservative investor. His part experience includes a few market cycles and he noted that "some have gone long on land during the last cycle when they opposite should be the goal." It is evident that Barcy relishes the role of the contrarian investor.

Hearthstone sees entitlement risk as political risk and attempts to avoid regulatory drama through their strategic partnering. Operating partners will have a proven track record. Hearthstone will work hard at a potential project outset to ensure they avoid any controversy they can, only proceeding with likely winners. This includes pre-screening the municipality to ensure community support, and investigating the flavor of elected officials. If any signs indicate an environment where approvals will be lengthy, Hearthstone will simply look elsewhere. The operating partner is responsible for being in the community early, doing charrettes, and engaging in consensus building.

One thing that Hearthstone faces that is unlike others is the commingling preferences of investors. Often, large pension funds like to be in control of directives and seek investment environments where they are the sole voice of decision. Barcy, with investors such as CALPERS, is often forced to find that balance and admits "you don't always want two eight hundred pound gorillas in the same cage."

⁴⁵ www.Hearthstone.com

Finally, Hearthstone makes an effort to generate brand awareness. Media outlets sought by the fund include the *Wall Street Journal* and *Builder Magazine*, although Barcy notes articles rarely bring any deals through the door. Furthermore, it is somewhat odd that a fund composed entirely of institutional capital would seek media exposure, but that is the case here. Good press is always a good strategy.

Returns

Hearthstone projects an 18 month entitlement process with most projects and Barcy admits that institutional capital has to be patient under these parameters. Returns, however, have proven that the wait is worthwhile. Returns are sought at 20% minimum with perhaps a 30% return with leverage. From the perspective of investor capital, it is not uncommon for Hearthstone to turn one dollar into three to five dollars for their investors.

Hearthstone structure and strategy has three primary outcomes. First, being an equity investor, they have lower risk and corresponding returns versus an outfit that is actively engaged in creating lots. Second, their fund size and partnerships with merchant builders indicate they are more prone to homogenous deals. Finally, the ability for this company to provide comfort to institutional investors given their arms length involvement appears tied to their higher internal incentives and co-investment requirement of fund managers.

AvalonBay Communities⁴⁶

Description

AvalonBay is one of the nation's largest and most dominant residential REITs. It acquires, develops, and operates multi family properties throughout the country with market focus in areas with high barriers to entry including California, the Northeast, and the Mid-Atlantic. The company is based in Alexandria, Virginia.

Organization

Due to the size and legal requirement of a REIT, the organization of AvalonBay is highly structured and corporate in nature. The development business is handled in regional divisions with Senior Vice Presidents handling the acquisitions and opportunity seeking. These individuals facilitate the entitlement process. The inquiry into the entitlement strategy of AvalonBay was generously answered by William McLaughlin, the Senior VP for the Massachusetts and New Jersey market.

In the broadest sense, McLaughlin does not view the climbing capital to be any sort of sea change in the industry. He attributes the increasing presence of capital climbing the risk curve to there being more capital to climb. Fundamentally "there is a boatload of capital, the returns are getting squeezed, and the greatest value is added through entitlements."

Deals are sourced either through brokers or those "in the business." As an established REIT they also benefit from a branded identity and the potential for landowners to contact them directly.

Strategy

McLaughlin and AvalonBay believe that "all real estate is local." In the Northeast this is particularly prevalent. Perhaps due to the prevalence of town governments over regional or county governments elsewhere, the Northeast suffers from stringent "home rule" where a development entity from the next town over is considered an outsider and treated accordingly. In order to usher projects through construction, the firm considers its primary strategic move to be

⁴⁶ Commentary generated from phone interview conducted with Bill McLaughlin, Senior Vice President for Massachusetts and New Jersey, AvalonBay Communities on June 16, 2007.

hiring a local attorney, who essentially serves as a local lobbyist. The attorney selected would have the track record and connections to get a project pushed through government. Hiring the local attorney is the fundamental way AvalonBay mitigates entitlement risk. They also hire a local civil engineer early in the process. Ideally, this would be a former planning board or zoning board member who still maintains local political connections.

AvalonBay does not consider itself to be in the business of entitlement flipping. Although there are instances where they have sold an entitled parcel, the firm views its long term strength lying in its property management, creating exceptional value over time in the eyes of their tenants and investors. Naturally, as a REIT, they are in the position of needing to generate recurring income which makes entitlement for entitlement's sake unappealing. They need the finished asset to generate cash flow.

Finally, AvalonBay does purchase pre-entitled parcels and is willing to pay a premium to do so. This strategy is particularly prevalent in markets with extremely difficult municipal development attitudes, where entitlement may ultimately be the result of human capital that the firm may not possess and be unable to pay for in the near term.

Terms of JV Deals

As a vertically integrated REIT, AvalonBay does not engage in JV deals in a similar fashion to other firms reviewed. While strategic local partnering is likely, they still would expect to maintain control in the execution of the projects.

Returns

McLaughlin notes that obtaining entitlements can easily translate into a 100% IRR between raw land and platted parcels. In fact, in an IRR driven entity, the highest return achievable would be to sell the entity the day you get the final permit. From the REIT perspective, however, they would be unable to quickly and profitably place this capital due to transaction costs. Since AvalonBay is typically focused on a long term hold, the returns to their entitlement are difficult to parse. Their strategy of building in challenging regulatory locations with an eye towards long

term holds makes it difficult to compare their returns to others interviewed for reflection of entitlement value.

Heitman⁴⁷

Description

Heitman is a private equity firm based in Chicago. Their Director of Research, Mary Ludgin, has witnessed an increasing interest in investment in un-entitled projects across the country. This trend is expanding and noteworthy. Heitman has historically focused on industrial development and is therefore follows closely the development strategies of firms like ProLogis and AMB, but whereas five years ago these JV deals with those companies would be for projects under full permit, they are now a collection of projects which may or may not include entitlements.

Ludgin suggests there is a history of entitlements within institutional investing, it just used to exist at the fringes of possibility. In the late 1980s there was considerable entitlement investment, called land speculation at the time that resulted in poor performance, especially leading up to the early 1990s. Heitman engaged in some of these deals that were success stories. For example, one of Heitman's deals in the late 1980s involved teaming up with a telephone pension plan to construct ski condos at Snowmass in Colorado. This investment involved complete entitlement risk.

Due to yield compression, the market is witnessing less build-to-core type investments and the investment firms are being forced to accept a bit more risk. As an example, Ludgin mentioned a recently approved industrial investment in New Jersey. Generally speaking, industrial buildings as an asset class may represent the most commoditized of building types. A warehouse, or a line factory, or a processing plant are similar buildings built in various locations that likely have little interaction with their physical location. In that sense, there is little "user preference" risk. This recently approved project, however, has plenty of entitlement risk that helps illustrate some common hurdles that are now acceptable to investors. The land earmarked for this building straddles two New Jersey municipalities. This requires one town to cede land to the other town which obviously necessitates interaction between many parties at the municipal level. An agreement will be required between parties that the donor town will be compensated for lost tax revenue in perpetuity, then an agreement must be reached regarding utilities to the lot, servicing

⁴⁷ Commentary generated from phone interview conducted with Mary Ludgin, President of Research, Heitman on June 25, 2007.

the utilities, and the receiving municipality must accept the responsibility of police and fire protection.

Once the parcel is associated with one town, the usual requirements need to be met. This involves changing zoning to meet the particular industrial purpose. Once zoning is changed, the building will proceed through the typical regulatory hurdles including code enforcement and building inspections. Although the process itself is typical of any building being built, it is noteworthy that investors are willing to take on the risk, and so early in the process.

Organization

As might be expected of a private equity manager, Heitman does not have entitlement staff in-house. They do, however, hire outside consultants within the relevant jurisdiction to provide due diligence on their opportunities.

Strategy

To chase the diminishing returns in the real estate investment arena, Heitman has been forced to engage in three strategies. First, they have found themselves expanding geographically. Initially, this meant Europe for industrial opportunities outside first tier cities. In the past few years, however, this has broadened to include Eastern European locations. Within the last year, Heitman has engaged in an investment in Russia for the first time, and in a project that does not have entitlements in place.

In emerging market circumstances, the firm provides comfort to investors by using investment caps on the percentage of the total fund that will be allocated to risky joint ventures. With each fund, Heitman has been able to get a bit deeper and more ambitious with their investments by following a strategic sequential path. The steps are first to invest in core properties that are operating and providing cash flow, then participate in ground up development with a local JV partner, and finally attempt a completely un-entitled project in a foreign market. These are the three risk profile options in foreign markets and Heitman sees their relevance increasing dramatically over the coming years.

A second new strategy is the expansion of acceptable property types. Heitman, and its investors, have gained increasing comfort with investing in property types beyond the four core categories. Mary suggests this may be a result of the emerging popularity of mixed use projects that may have given investors increasing confidence in unorthodox property mixes. Heitman will look for opportunities that involve unique value add opportunities. One possible project involved re-orienting a retail project that Heitman believed could handle the addition of some residential development. This process involved two mayoral cycles and two city planning administrations. The project never came together and is therefore representative of the risk involved in entitlement plays.

Finally, and most relevant to chasing diminishing returns, has been the broadening of acceptable risk profiles among the investors. This has been the result of the squeeze on yields and total returns. The broadening has exposed them to ever more deals that include land development and therefore, exposure to entitlement risk. This is particularly noteworthy with Heitman because their primary investors are pension plans, who traditionally would view real estate investment from the income perspective. As indicated elsewhere, the key component of an un-entitled parcel of land is its inability to spin off cash flow, and therefore, it is interesting to see the traditionally cash flow hungry pension plans gaining some comfort with this strategy. Before 2001, it was rare for a pension plan to agree to forego income for an unspecified period of time.

One interesting note is that of all institutional investors, it is often the university endowments that are most willing to innovate with their capital. The mission of these funds seem to offer great comfort in risk taking. While endowments as innovators was a frequent comment in the discussions with industry representatives, one investment consultant clarified that often endowments have the pre-eminent mandate to generate returns and are not working with consultants as fiduciaries.⁴⁸ This places them at the "bleeding edge" of risk. However, this individual is now seeing increasing boldness among pension funds, which is personified in the speed with which policy changes are now made in pension fund board rooms.

⁴⁸ Commentary generated from phone interview conducted with Micolyn Yolani, The Townsend Group, on July 3, 2007.

Heitman strategically recognizes that geography can sometimes drive policy. They are careful to avoid areas with hyper-politicized environments. In general, Ludgin indicates that land scarcity has a tight correlation to protracted land battles. This may be particularly relevant in areas where there is an elevated awareness of topography or land character. In San Francisco, for example, the community seems very protective of maintaining its topography of hills as a testament to the character of the space. Building a high rise on top of a hill will not be permitted. As a counterpoint, one might consider Chicago. Chicago is generally considered a pro-development area, which some attribute to the fact that Chicago has very little in terms of dramatic topography. Citizens have collectively decided to use architecture and the built environment to create drama and excitement. The buildings are allowed to become the topography.

Returns

The perspective of this type of entity is that a fund earmarked for an entitlement level project would be classified as an opportunity fund or value added fund. Heitman does participate in a lot of value add funds, but in accordance with investor expectations, must include a cash flow generating asset. This inclusion is their strategy for spreading risk and is what would differentiate a value add or opportunity fund at Heitman versus someone like Hearthstone.

The industrial sector returns at Heitman have been squeezed over the past few years. On a recent campus type development, they achieved a 10% property level IRR which compares to returns seen a few years ago in the 12% range. As a general rule, the firm seeks industrial returns to be about 1% greater than residential returns.

Chapter 6 - Synthesis

Introduction

Entitlements are information intensive and should favor local players. Indeed, if entitlements are a local game, how do national entities with billions of dollars to invest compete? If the major hurdle to entitlements is local knowledge and credibility, then non-local firms should illustrate organizations and strategies to overcome these weaknesses. If successful, these firms will, at a minimum, create parity between themselves and a local player and possibly leverage their skills into a competitive advantage. Firm strategies are personified by organizational structures and can be assessed through several channels: geographical focus, capital access, deal sourcing, and timing. The tradeoffs between these components will direct investment strategy and ultimately determine financial success.

Geographic Focus

The geographic focus of these entities has implications for their confidence in local knowledge. The subject firms indicate that location familiarity may enable them to take on bigger entitlement fights, such as re-zonings. Those with less inclination or location information will engage in as-of-right deals to diminish some of the process uncertainty. The spectrum ranges from as-of-right deals to investing with full uncertainty in foreign markets.

- Land Equity Partners leverages the skill set of its partners and long standing relationships to provide the needed confidence to get projects entitled. Projects undertaken in newer territories, such as Montana, tend to be in areas where greenfield residential development is relatively straightforward and use plans that follow as-of-right stipulations.
- AvalonBay Communities focuses on well defined (and researched) markets with high barriers to entry. In these locations, their corporate scale, pocketbook, and past experience provides local knowledge to greatly reduce risk. Typically, AvalonBay will also do as-of-right development. The region focus, repeating nature of their projects also provides comfort to municipalities in terms of quality and completion guarantees when a zoning change or entitlement issue is encountered.
- Hearthstone gains confidence through diversification. Their capital resources establish a portfolio effect that defends against the goofy realities of entitlements in different

jurisdictions. Additionally, Hearthstone benefits from the knowledge of their executives in terms of project viability.

- Dunmore has a local focus that employs the local connections of its entitlement staff, who have pre-existing relationships with planning authorities, to seek more intensive entitlement battles, such as re-zonings.
- Heitman gains comfort and "becomes local" through a project succession approach. In a foreign location, for example, they first purchase a cash flowing asset, then supply equity to a JV with a local player, and finally, take on full entitlement risk. This position is far from "as-of-right" and illustrates a particularly aggressive strategy.

Capital Access

These firms raise capital through a combination of the following resources: public institutional equity, private domestic equity, private international equity, or stock proceeds. Bigger appears better. With funds ranging from \$20 million with Land Equity Partners to \$1 billion with Hearthstone, it appears that the bigger purse provides a portfolio effect of project selection. It is interesting to note that Dunmore, long established and successful in California, is branching into additional markets as they generate their first \$150 million fund. Although too early to tell, one wonders if this new equity is forcing this firm into unfamiliar territory at the expense of their "bread and butter" marketplace.

Speaking with the interviewees indicated relative ease accessing capital. Hearthstone, for example, initially aimed to generate a \$150 million fund. CalPERS alone contributed \$450 million and Hearthstone quickly altered course to a \$2 billion goal!⁴⁹ CalPERS is drawn to the Hearthstone model due to its past success in investing in residential land development. They have achieved a 15% annual return on raw land and single family construction since 1992.⁵⁰ The larger funds also benefit from the largely institutional capital as this tends to be more patient equity than some of the high net worth individuals investing in either the Land Equity Partners or Dunmore's funds.

⁴⁹ Hagerty, James R. "Real Estate Finance: Housing Duo Focuses on Raw Land; Firm Looks Ahead 5 Years to Plan New Developments in Political 'Chess Game'". *Wall Street Journal*, July 12, 2006, pB11.

⁵⁰ *Ibid*, pB11.

If the fundamental hedge against entitlement battles is money, and institutional capital is present in the entitlement phase, then the local player is again at a disadvantage. Perhaps the role of the local developer is changing. Maybe the local entity should serve more as a conduit for institutional capital, serving as a broker to development. Developers should consider employing the resources of entitlement only funds over funds provided by banks. The funds are more sympathetic, have money earmarked for the purpose and should make good partners.

Deal Sourcing

If capital isn't a problem, then finding legitimate deals can be. These firms use three techniques to overcome the advantage of the well connected local player. I call these strategies: "ear to the ground," pre-partnering, and conventional. Ear to the ground describes the strategy accepting all leads whether in-house or third party and lacks a repeatable methodology. Pre-partnering is used when the equity partner and development partner enter an agreement prior to even considering deals. Conventional deal sourcing is the methodical approach of culling sales and market information, accepting cues from brokers, and front loading due diligence prior to looking for projects. This strategy is different from ear to the ground in that there is a strategic geographic direction in mind.

- Land Equity Partners engaged in the "ear to the ground" strategy in the past. This worked for them due to their long standing area relationships, and the fact that at the time they would be considered a "local player." Now they use a more conventional approach.
- AvalonBay notes that their profile and size often brings in quiet deals. They also have a "surrogate" ear to the ground in the form of brokers and consultants that may bring a parcel or landowner to their attention prior to going to market.
- Hearthstone is attempting the structured pre-partnering approach by pre-qualifying home builders who use Hearthstone equity for the entitlement and infrastructure process. This capital flow creates incentive for the builder partners to lend their local knowledge to site selection. While this symbiotic relationship works well, this method would require diligence from all involved to ensure builder project selection quality doesn't decline as a result of a softening market leading to builder desperation. Relying too much on pre-qualified partners seems to remove Hearthstone one step from touching and feeling the real estate. This may create an agency affect whereby they must constantly monitor deal

quality or set up additional incentive to align interests with those who bring good deals and punish those that bring weak deals.

- Heitman engages in a hybrid of conventional and ear to the ground. They use their own past experience and past successes to expose them to future deals and gain confidence in their ability in a given location.
- Dunmore is relentlessly pursuing their marketplace in-house using conventional due-diligence methods. Dunmore has also restricted their market, providing a greater information base about the communities in which they operate. It may not be a coincidence, therefore, that Dunmore is seeing the best stated returns, over a 40% average IRR over the past 20 deals.

Timing

Timing was a critical consideration to varying degrees among these firms. The variation runs from the extremely patient view of time at Heitman, to the expeditious mandate of Land Equity Partners.

- Heitman is subject to the timing parameters of their investors. They are witnessing greater patience in the historically conservation pension fund area. Heitman's geographical strategy embodies the patient nature of their capital. As referenced above, the "project ladder" used to gain area confidence will take time and illustrates that Heitman sees the investment of time in truly getting to know an area as a worthwhile endeavor.
- Dunmore and Hearthstone, both with an extensive California experience in locations that regularly require rezonings, seemed to accept that time was an uncontrollable variable.
- The high barriers to entry locations of AvalonBay demands they beat competitors, and makes timing a critical issue, not only in site selection but also the entitlement constrained race to bring their product to market. Their timing strategy was two fold. First, they make hiring and management decisions partially on the applicants area knowledge. Second, their replication strategy ensures a growing track record of finished operating properties to illustrate their trustworthiness and professionalism which they believe eases the entitlement process with municipalities.

- Land Equity Partners, proposing largely greenfield developments in less cumbersome regulatory environments, considered timing a critical element of their success and is willing to sell at a discount to preserve projected returns. One of LEP's greatest successes involved a project in Heber City, Utah. Leveraging skill and speed, LEP was able to entitle and sell an entire project under an option agreement leaving them with an "infinite return" given their only outlay was the option payment and sunk costs in the entitlement process.

The Entitlement Paradox

The entitlement paradox introduced at the outset of this paper suggested that local players have access, but lack capital while national players have deep pockets, but lack local knowledge. Findings from the interviewed firms suggest that the idiosyncratic nature of entitlements endorse a global approach where the diversification of project location creates a portfolio effect and more stable returns. Larger firms have access to patient capital, broader experience in more markets, exhaustive due diligence staff, and the ability to purchase local players for strategic connections. This enables these companies to reduce risk through a sort of human capital arbitrage in the entitlement process. This can help reduce the assumed superiority of the well connected local developer.

The success of the subject firms indicates two things. First, it is possible to reduce the local advantage in the entitlement process as an outsider. Whether through technology, partnerships, past relationships, picking less information intensive projects, these firms are able to place themselves in a position of authority and knowledge throughout the country and increasingly throughout the world. Second, the capital available for accomplishing these aims are broad, ranging from REITs to foreigner supported equity funds. Therefore, participating in the entitlement process is currently, and will continue to be, an emerging investment vehicle for a broad range of investors.

Chapter 7 - Conclusion

It has been assumed that entitlement success is highly correlated to location knowledge and credibility. Under this rubric, the local player with local connections is better positioned to extract the greatest value from the entitlement process. This is due to their better sense of market trends, which enables the wisest asset type selection and project proposal, as well as their local connections which ease the approvals process.

The growing presence of institutional capital in the entitlement process and increasing public vigilance has made the entitlement process more demanding and programmatic. There is less room for sweetheart deals when the approvals process is played out on community access television. The entitlement process has become more difficult as increasing zoning restrictions have created layers of complexity to land use and overlapping government jurisdictions have complicated the approvals process. Community members have become increasingly powerful and savvy in their campaigns to agitate for no development or development with significant strings attached. This web of complication results in a diminished bundle of sticks for the property owner and lessens control over property destiny. From the developer's perspective, this lack of control translates to one thing: risk.

To mitigate these increasing risks, developers have developed best practices as a means of ensuring returns. These strategies can be conventional or innovative and may relate to finance or politics. The goal of these strategies appears to be the acquisition of local knowledge and credibility in the eyes of stakeholders and municipalities. Firms representing institutional capital appear savvy at acquiring this local knowledge either through consultants, due diligence, or "purchasing" a local partner. The result is greater parity between local and non-local entitlement entities.

Fundamentally, success in the process is often determined by patience and time for which money serves as a powerful substitute. If nothing else, the deeper pockets enable the reduction of risk in the entitlement process and may be as simple as outlasting detractors. Under this realization, it is the conclusion of this investigation that the greatest path to mitigating risk in the entitlement

process is the ability to access cash. The former perception that local knowledge was the greatest hurdle for outside players in the entitlement process no longer applies. If this paradox exists, then we would see divergent organizations and strategies among the entitlement entities. And we do.

- Firms managing institutional capital with little or no in-house entitlement staff, and therefore diminished local knowledge, are more likely to engage in as-of-right developments.
- Firms that have exceptional market knowledge are more likely to engage in projects that may require more intensive entitlement battles, such as a re-zoning.

If local knowledge is the hurdle to outside investors in the local entitlement game then they have figured a way to jump over it; invest in getting the knowledge yourself, partner with a local player, and do easier deals that require less local knowledge. Following this path, the national players will continue to have entitlement success and bring their broadening party of investors along for the ride.

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Web Resources

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