The DRE makes two resources available to assist developers and their consultants in preparing budgets for approval by the DRE as part of the public report application process. *Operating Cost Manual for Homeowners Associations* and *Reserve Study Guidelines for Homeowners Association Budgets* are publications available from the DRE providing detailed guidelines and cost data for budget preparation.

Other Responsibilities

Management of the financial matters of the association is a large part of the job of the board of directors. This includes preparing the budgets and financial statements of the association, paying taxes and assessments on association property, contracting and paying for goods and services for the common areas including facilities and interests of the association such as insurance, and enforcing of the governing documents regarding dues and assessments.

The other main responsibility of the board is to enforce applicable provisions of the governing documents. This may include enforcing rules and modifying them as necessary, initiating and executing disciplinary proceedings against members for violating provisions of the governing documents, and holding elections and filling vacancies as required by the governing documents.

Specific powers of and limitations on the board will be included in the governing documents.

THE HOUSING DEVELOPMENT PROCESS

As mentioned above, the provisions of the SLA and the public report application process come into play toward the end of the overall subdivision development process. That is, the developer applies for a public report from the DRE just prior to the time that the developer begins marketing homes to the public. Yet at that time the majority of the development work has already been done. The DRE staff in effect reviews documentation of the developer's work through its application review. Thus, a basic understanding of the entire development process is necessary for a fuller understanding of the SLA.

Residential real estate development is considered a process because it is a linear, sequential series of actions designed to transform land, labor, and raw materials into places for people to live. It is a process that is well suited for the critical path method of project management and modeling.[7] Many of the tasks in the process cannot proceed until precedent actions have been completed. For example:

- A subdivision map cannot be approved until the environmental analysis required by CEQA has been completed.
- A subdivision map cannot be recorded and become of legal effect until conditions of approval have been satisfied.
- Building permits typically cannot be issued until the subdivision map has been recorded and the site improvements serving the homes have been installed.
- Homes cannot be sold until they have been approved for occupancy and a final public report issued (if required).

Thus, a typical development project will be managed according to a critical path schedule, designed to complete critical activities as expediently as possible. Meanwhile the developer will work to perform non-critical activities simultaneously so as to minimize the overall duration of the process. For example, during the time a developer is seeking approval of a subdivision map by the local agency, he/she will be conducting market research for homes to be built in the subdivision and seeking financing for the construction of the project.

[7] The "critical path method" is a project management technique developed by Morgan R. Walker of DuPont and James E. Kelley, Jr. of Remington Rand in the 1950s. The technique involves: 1) listing all activities that must be completed from the beginning to the end of the project; 2) organizing the activities sequentially based on dependency on other activities; 3) assigning timeframes to each activity; and 4) identifying each activity as critical or non-critical. Critical activities are those that make up the longest path, the longest path being the critical path. Management efforts are focused on minimizing the length of the critical path, meanwhile completing non-critical activities within the schedule of the critical path.

Duration of the Development Process

One of the most important and most challenging tasks for the developer is to manage and account for the duration of the development process in his/her business plan. The duration of the development process – from the acquisition of raw land to the sale of the last home in the subdivision – can be unpredictable and quite lengthy. Extended project duration often is the determining factor in whether or not the project is successful.

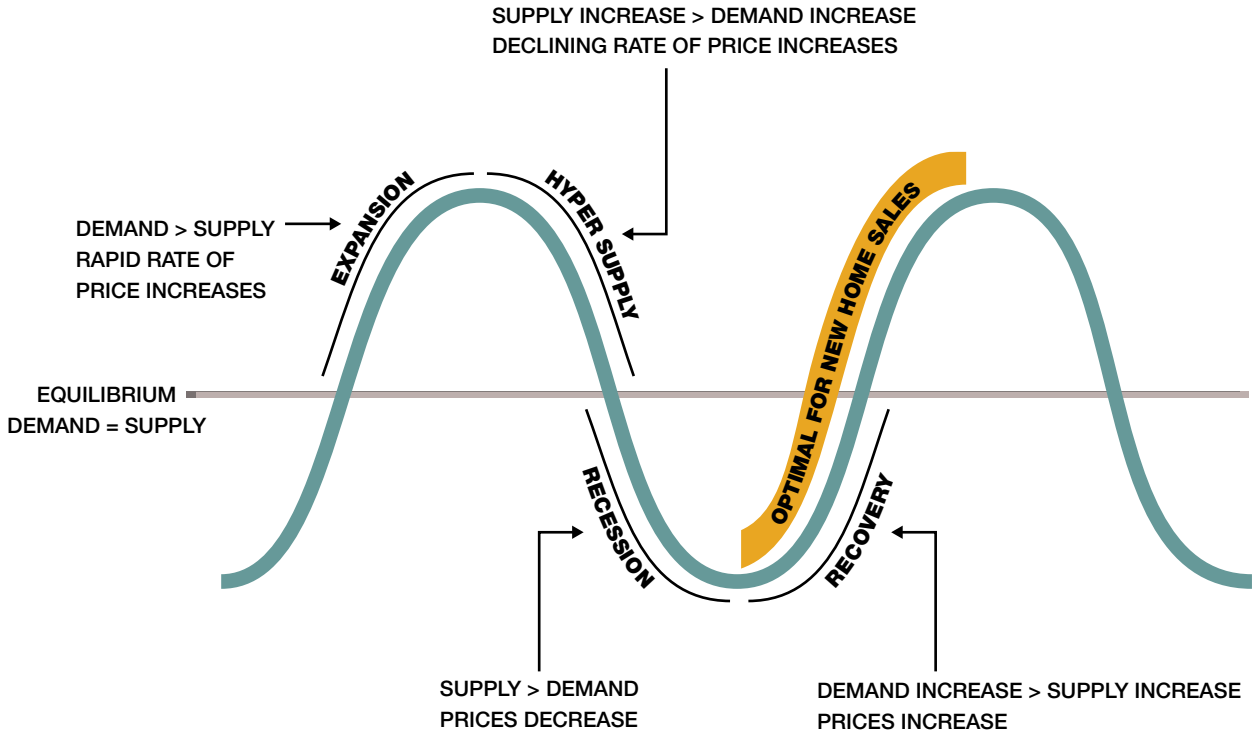
The Real Estate Cycle and the Supply-Demand Gap

The difficulty of a project's duration is best understood by first understanding the real estate cycle. The experience of the housing market of the early 2000s and the downturn and corresponding recession of 2007-2009 illustrate the volatility of real estate prices. This experience reinforced the fact that real estate prices are represented not by an ascending straight line, but more accurately by a sine wave varying over time.

The level of home sales and prices vary with changes in supply and demand. New supply is driven by housing developers who base their decisions to build new housing on the inventory and price of existing housing, the costs of developing new housing, the competition from other new housing, and expectations about the future of these and other economic conditions. Changes in housing demand occur due to changes in economic, demographic, and psychographic factors. Economic factors include things such as wealth, income, and the cost and availability of credit (interest rates), which would enable a home purchase. Housing demand is driven by household formation among consumers who exhibit the key demographic characteristics of homebuyers, such as age, household size, ethnicity, etc. Psychographic factors are those psychological factors that contribute to the home purchase decision such as consumer confidence, the "wealth effect," and views of homeownership as an investment.

Changes in supply and demand are represented by a graph of the real estate cycle as shown in Figure 6.

Figure 6 - The Real Estate Cycle



The cycle is divided into four stages based on the relationship of the supply and demand for new homes. "Equilibrium" is that theoretical point in the market where demand equals supply, i.e., the number of new homes built and sold is exactly enough to meet the demand for new homes at any point in time. At equilibrium, if a builder could instantaneously increase or decrease production to meet demand, prices would remain stable because production would be just enough to meet demand.

Of course, it is not possible for the developer to have perfect knowledge of all demand and supply factors and, thus, it is not possible for production to be controlled in this manner. The duration of the development process – from raw unentitled land to homes available for sale – extends over several years. This leads to a frequent gap between supply and demand that tends to exacerbate the crests and troughs of the real estate cycle. Consequently, to meet today's demand for new homes, the development process for a project must have been started several years ago. To the extent there is an insufficient supply of land in the pipeline (see Figure 7), there will be a shortage, resulting in upward pressure on home prices. As more housing is developed to meet market demand, the likelihood of overbuilding is increased as supply may continue to increase even when market demand recedes. The developer's best prospect for success in such an environment is to begin and end a project in one cycle with the majority of home sales occurring on the upward part of the cycle. Thus, the longer the duration of the project, the more the project will be subject to a downturn in the cycle.

Peculiar to the "expansion" and "hyper supply" stages of the cycle shown in Figure 6 is the prevalence of condominium conversions. In many geographic areas, attached housing serves as a "substitute product" for detached housing. That is, as prices for single-family detached homes rise during the expansion stage, demand for lower priced alternatives such as condominiums increases. While developers may seek to develop new condominium projects to meet demand, the conversion of rental apartments to ownership condominiums during such periods may be appealing due to: 1) a perceived disproportionate difference between the cost of rental apartments and projected sale prices of the apartments converted to condominiums; 2) a potentially shorter and simpler land use entitlement process compared to new construction; and 3) a less extensive and less intensive construction process since improvements are already in place. An increase in condominium conversions may be viewed as an indicator of the expansion stage of the cycle as it moves toward the hyper supply stage.

The above factors make the quality of the unit delivered to the buyer and the quality of the common area delivered to the HOA of primary concern to homebuyers and to the DRE. Converters are likely able to acquire older and lower quality apartments at a lower cost with more perceived profit potential than newer or higher quality apartments. Older and lower quality apartments are also likely to require corrections and improvements that go beyond typical cosmetic improvements necessary to attract homebuyers. In addition to exterior improvements that are visible and somewhat obvious, such as roofing, siding, paving, and landscaping, nonvisible improvements such as infrastructure, mechanical, electrical, and plumbing systems may require significant rehabilitation or updating. The DRE's HOA budget review and acceptance process requires condominium converters to submit reserve studies that estimate the funds necessary for the HOA to take over the project's maintenance responsibilities; however, condominium converters often are not long-term owners of the property prior to conversion, and therefore do not have direct knowledge of a project's true maintenance or operational costs. Thus, there are limits to the amount of disclosure and the reliability of budget estimates for conversion projects. Consequently, homebuyers may be surprised by actual property needs and increases in assessments to address such needs after the developer's obligation to pay assessments pursuant to Regulation 2792.9 has expired.

The "recession" stage of the real estate cycle is a challenging environment for the developer, homebuyers (particularly in CIDs or attached housing projects), and HOAs. The market downturn of 2007 highlighted problems that can arise in projects where HOAs are involved. DRE regulations (specifically Regulation 2792.9) require a subdivider to assure the availability of funds or sources of funds for the early stages of an HOA's operations. When the downturn occurred, the response of developers of single-family detached homes was to simply stop building homes as sales slowed. Developers of attached homes had less flexibility in that structures containing multiple units

were completed where only one or a few units in the structure were sold. Thus, a large inventory of unsold homes was created when sales programs were suspended. Often, the subdivider or the subdivider's lender following a foreclosure on the construction loan, rented out the unsold units. These rentals, combined with the rentals by investor-owners that purchased foreclosed homeowners' units, led to percentages of non-owner occupied units that exceeded limits established by FHA, Fannie Mae, and Freddie Mac project qualification for mortgage financing. The poor health of the HOAs due to the foreclosures also affected qualification by these agencies. Potential owner-occupant buyers were thereby precluded from obtaining traditional financing for these types of projects.

The recession caused many homeowners to default on their mortgage loans and HOA assessments leading to foreclosure by the first mortgage lender. When a lender forecloses on a separate lot or unit, any HOA lien for unpaid assessments is eliminated due to the mortgagee protection clause of CC&Rs (discussed on page 66), which causes HOA liens to be subordinated to the first mortgage lien. Upon foreclosure, the lender becomes obligated to pay HOA assessments from that point forward. The loss of revenue from defaulting homeowners prior to lender foreclosure took a toll on many HOAs. Such losses were exacerbated by extended default periods, as lenders were slow to actually complete the foreclosure process. HOAs that maintained and provided property insurance for individual lots or units – the cost of which is a significant portion of the entire budget and significantly higher than HOAs that only provide for insurance and maintenance for common areas – were impacted even more.

HOAs were unprepared for the unprecedented high number of foreclosures during the recession, and they were unable to adequately address the extraordinarily high assessment delinquency and default rates within their communities. Many initially wrote off the delinquent assessments following a lender's foreclosure, closed the books on the defaulting accounts, and made up the funding shortfall by increasing the HOA's annual regular assessments. Later, they began seeking monetary judgments from defaulting homeowners, assigning those debts to third party collection companies and agreeing to accept only a portion of any debt collected.

Ex Ante Analysis and Project Delays

The duration of the development process requires a developer to make decisions based on expectations of what conditions will be several years into the future. Such feasibility decisions are based on many assumptions made very early in the process. Making this analysis even more critical is the fact that development projects require large amounts of capital to be invested for long, potentially indefinite, periods of time. A project likely will require the developer to invest substantial resources years in advance of actually realizing any revenue or profits. The price paid for the property, obligations made to lenders, and returns promised to investors, among other decisions, are committed to well in advance of actual home sales and project completion. Once invested, capital is not easily recovered, particularly if the project performs worse than expected. Unlike income-producing investments, which provide cash flow to the investor throughout the investment period and, at the end of the investment period when the asset is sold, the return on investment in a for sale residential project is provided solely at the end of the investment period. Meanwhile, funds are tied up in a very illiquid asset.

If the project schedule extends beyond what was anticipated by the developer, the developer will incur additional costs. The longer the duration of the project, the greater the risk of costs being greater and/or revenues being lower than projected. Government regulations, building codes, and development fees and exactions tend to increase over time leading to increased costs of compliance. Tentative maps and other permits have expiration dates by which certain conditions must be met. An extended schedule increases actual land holding costs (interest accrual, property taxes, property maintenance costs, job overhead) and increases the risk of such things occurring.

Factors Affecting Project Duration

The duration of the process is affected by a variety of factors:

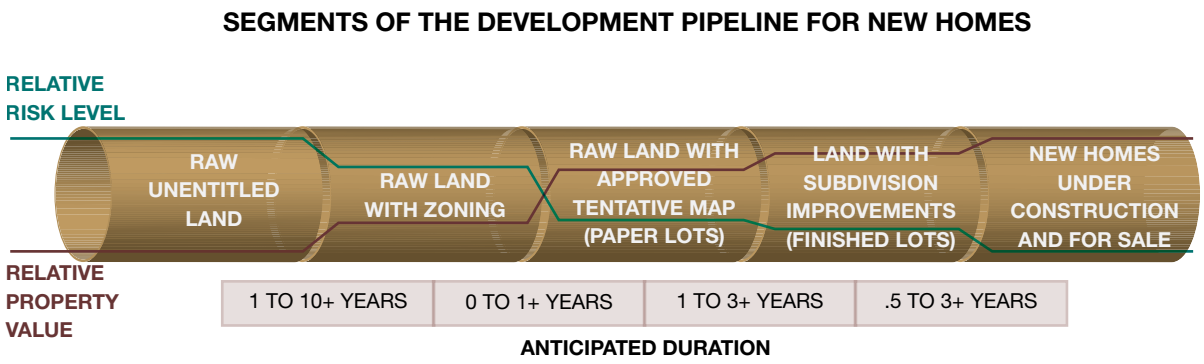
- The land use entitlement and permitting process is necessary for the project. The status of the entitlements of raw land can vary greatly from having no right to develop, such as under agricultural zoning where the land may need to be annexed by a municipality, to a property of "paper" lots, where a tentative map has

already been approved but no further development has occurred. Many variables will affect the duration of the entitlement process such as:

- Whether the required zoning is consistent with the local agency's land use plans
- Whether the land requires federal and/or state permits under the Clean Water Act or Endangered Species Act and if so, what type of permit is required
- The local agency's processing procedures and timeline
- The CEQA process required
- Whether the project is controversial

As a result of the above variables, at any given time there is a supply pipeline of developable lots at various stages of the development process as illustrated in Figure 7.

Figure 7 - The Development Pipeline



One of the biggest risks associated with the development process is ***entitlement risk***, i.e., the risk that the discretionary land use approvals needed to develop the project are not obtained with conditions that allow the project to be feasibly developed in the anticipated timeframe. The closer in time and in regulatory procedure the land is to being able to pull building permits and sell homes, the less the project is subject to variations in the market cycle. Consequently, land becomes more valuable as it gains entitlement approvals. In this way, the segmentation of land supply leads to specialization in the development industry; e.g., land developers may focus on buying land, entitling it, and selling it to homebuilders. A homebuilder may, and frequently does, forego entitlement risk by choosing to purchase land only after it has been approved with all land use entitlements in place.

- The size of the project: The larger the project, the longer it will take to install subdivision improvements and the longer it will take to sell all of the homes in the subdivision. Larger projects are typically phased in order to manage costs and to better match development costs to projected sales. Even with phasing, larger projects are challenged to meet the rate of sales at any given time. For example, assume that subdivision improvements are installed for a phase of 100 lots where sales of homes occur at an average rate of four homes per month. It would take 25 months for the phase to sell out. The developer is susceptible to downturns in the market during that time.
- The complexity of the project: Projects requiring installation of major "off-site" improvements such as large or extended utility lines or street improvements, or major infrastructure improvements, relocations, demolitions, etc. take longer to design and to construct.

- The developer's financial readiness to proceed: Depending on the developer's individual circumstances, a developer may not have the financing immediately available to proceed with development of the project.
- Seasonality and weather: Construction is seasonal. Due to unfavorable weather conditions and governmental regulations related to environmental quality, construction can only efficiently occur during certain times of the year, generally April through October depending on actual weather conditions. Project delays can easily cause a construction season to be missed, leading to even longer project delays. Home sales are also seasonal. The traditional homebuying season is from February to September. Of course home sales occur year-round, but more sales occur during these months due to school schedules and more favorable weather. Project delays may cause the developer to miss the opportunity to sell homes during the peak season.
- Market conditions: As discussed above, market conditions vary and will determine how long it will take to sell all homes in the subdivision.

Project Development Overview

Successful real estate development requires both vision and execution. Vision involves the conceptualization of the project to be developed on a given site taking a variety of factors into consideration, well before actually bringing homes to market. Such factors include:

- Site and location factors: What offsite amenities are available? Based on surrounding and nearby land uses, is the property a good site for housing? If so, what housing type is best suited for the site? What design is appropriate given the features and constraints of the site? What on-site amenities should be offered? What scope of off-site and on-site improvements will be necessary to build housing on the site?
- Market factors: What type of product should be built on the site? What features should be offered? At what price can homes be sold? Given market demand, how many homes can be sold and how long will it take to sell all of the homes in the project?
- Financial factors: How much will it cost to develop the project? Is it financeable given the level of returns? What is the pro forma financial performance of the project?
- Regulatory factors: What approvals are necessary to be able to develop the site? How long will it take to obtain approvals? Is approval possible within the investment horizon? What are likely conditions of approval of the project?

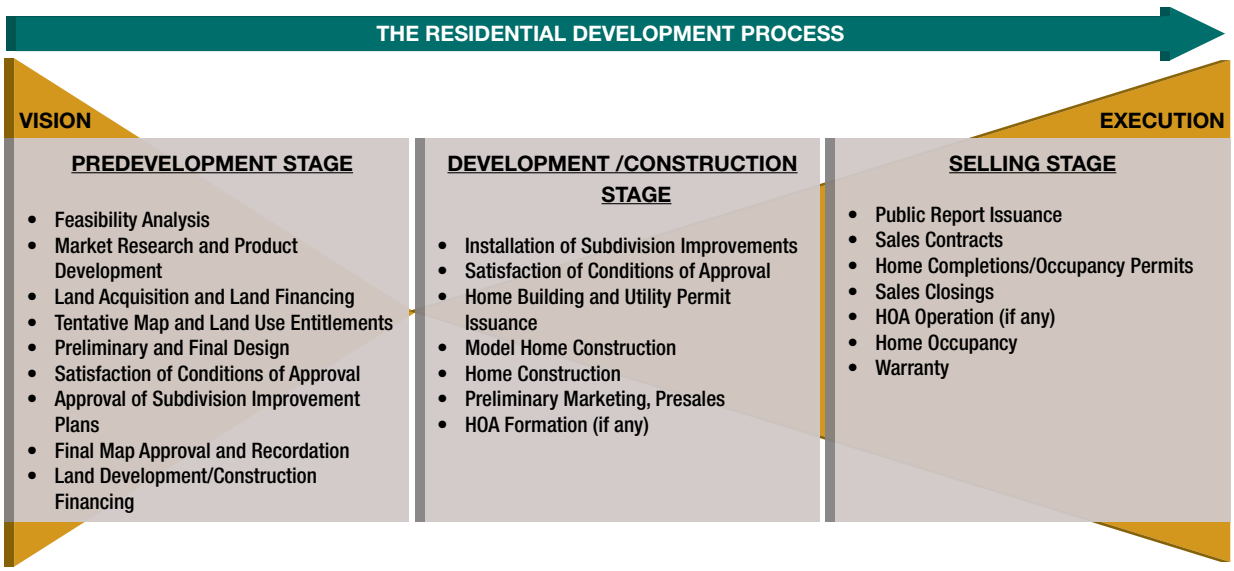
Analyzing the site for these and other factors will lead to a preliminary definition of the project. Once the project concept has been defined, it must be executed. That is, the project, starting from no more than a drawing on paper, must be developed and advanced through a complex process of regulations and procedures to prepare it for construction, and then it must be constructed, marketed, and sold to the public.

Between the initial vision and final execution of a project there are many tasks and activities that must be completed in order for the project to be developed. This process can be broken down into three stages – predevelopment, development and construction, and selling – as summarized in Figure 8.

Predevelopment Stage

The predevelopment stage is the period from when the project is first considered to the time that construction commences on the site. The first task of the developer is to find a site that is suitable, marketable, and feasible for new housing. In conducting a search for potential development sites, a developer will narrow the search by determining the housing type to develop, the geographic market area, and other specific criteria from the developer's business plan. In addition to identifying sites by drive-by surveys, real estate brokers may assist in the search, and developers may conduct research at local planning departments to find developable sites. Prior to selecting a site and beginning to negotiate a purchase and sale agreement of a site, it is likely that the developer will have considered and analyzed several sites for development.

Figure 8 - The Residential Development Process



Feasibility Analysis

Once potential sites have been identified, the developer will begin to conduct simple feasibility analyses on the sites. Various levels of feasibility analysis will be conducted during the course of any project. The first level of analysis may be referred to as "quick and dirty," "back of the envelope," or "back of the napkin" analysis, indicating the preliminary and cursory nature of the analysis. Prior to expending significant resources or contacting the seller of a property, the developer will generate a simple financial analysis using estimates and assumptions based on the developer's experience, e.g., the number of units that can be built on the site, sales values, development costs, etc. If the preliminary analysis is promising, the developer will proceed with more detailed analyses to further validate the preliminary feasibility of the project and to determine the purchase price and other terms to offer the seller of the property.

The essence of a feasibility analysis is to quantify and project the timing of all the costs of development and the anticipated revenues from the project. If projected revenues exceed the total cost (including the costs of financing) so that an adequate profit can be earned by the developer, the developer will proceed with the project. This *pro forma* analysis is the basis for many decisions that are made throughout the development process. In order for the developer to actually proceed with the project, he/she must raise the funds necessary to complete each stage of the project. In order for the project to be successful, the assumptions made in the pro forma analysis must prove out.

Accurately quantifying and projecting costs and revenues is an extremely difficult task. Not only do the physical costs of development need to be estimated, but the timing of costs and revenues need to be projected as well. Underestimating costs and/or overestimating revenues will lead to an unsuccessful project. Overestimating costs and/or underestimating revenues will likely lead to the developer failing to proceed with what otherwise would be a successful project, i.e., the developer's offer to buy the property, the price of which is based on the developer's projections, will likely be rejected by the land seller who may otherwise accept a higher competing offer.

Once the initial project pro forma has been established, it serves as the main management tool for the developer. Integrated into the pro forma are the project schedule, the project budget, the projected cash flow (sources of cash from equity, debt financing, and home sales, and uses of cash for project costs), and measures of the financial performance of the project. The project pro forma will be updated periodically, particularly as needed to account for significant changes in the market or budget or in anticipation of presentation to lenders or investors.

In analyzing a site for residential development, the developer will analyze two categories of factors: internal factors (factors related to the site itself) and external factors (how the property relates to other land uses and amenities that are important to homebuyers).

Internal Factors. Internal factors are those that are unique to an individual site and integral to its development. Internal factors ultimately increase or decrease the value of the site in the marketplace. This site analysis is primarily concerned with the cost of development. With raw land, there are a myriad of factors that must be analyzed with regard to the developability of the site and the associated cost of development.

- Existing conditions: In analyzing the site for feasibility of development, the developer must understand the current and previous uses of the site. Previous uses of the site may be an indicator of the possibility of contamination on the site or of improvements that may remain on the site that may be costly to remove. Existing conditions include site drainage, soil conditions, topography, and vegetation on the site. Drainage conditions of the site will determine the extent of grading necessary and the scope of storm drainage improvements necessary to adequately manage storm water runoff from the site. Drainage conditions may indicate the presence of wetlands or vernal pools, which require permits from regulatory agencies in order to be filled with soil. Other natural conditions such as habitat for endangered or threatened species may be subject to federal, state, and/or local regulations. If such regulations apply, the approval and compliance process for these permits must be analyzed (see Land use entitlements and tentative map). Attractive natural conditions may lead to a decision to preserve them and incorporate them into the development plan.
  The developer will also verify the status of the property with regard to flood hazard by reviewing the flood risk designation for the property as determined by the Federal Emergency Management Agency (FEMA). This designation is a basis for determining whether the property is developable, and whether flood insurance will be mandatory for future homeowners. A flood insurance requirement and the rates homes in the project will be subject to may affect the marketing of homes in the subdivision.
  The properties of soils, the depth of groundwater, and bedrock on the site must be taken into consideration when designing and installing improvements for the site. The developer will employ a specialized civil engineer, called a geotechnical engineer, to provide design recommendations for grading, street improvements, building foundations, etc. Failure to properly consider soil conditions can lead to the failure of the improvements themselves and liability to the developer.
- Potential for environmental contamination: The Comprehensive Environmental Response, Compensation, and Liability Act is a federal law, the effect of which is to impose liability on any owner or lender on property that is contaminated with materials defined as hazardous, whether the owner or lender caused the contamination or not. In order to minimize liability under this law, developers will hire a consultant, typically a geotechnical engineer or an engineer specializing in such matters, to conduct an environmental assessment on the property. The environmental assessment includes a review of current and historic conditions on the site and the area surrounding the property, and public records to assess the likelihood that the site is affected by contamination from hazardous materials. Various levels of analysis may be done, including actually analyzing soil samples on the site, depending on the likelihood that the site has been contaminated. If contamination is found, and to the extent the developer wishes to proceed with the project, the developer will need to remove the contamination or remediate it to a level acceptable to relevant regulatory agencies.
- Off-site improvements necessary for development: Off-site improvements are extraordinary improvements or improvements outside the boundaries of the site itself that must be constructed to serve the project. Examples of off-site improvements are major utility facilities, extensions of utility lines, or road improvements to connect and serve the property to adequate infrastructure. A developer will employ a civil engineer, working in conjunction with the local agency's public works or engineering department, to determine the scope and cost of off-site improvements necessary to develop the project. The analysis of off-site utilities will also include a determination as to whether the project will be allowed to connect to

existing utilities based on the capacity of existing systems and the physical and financial requirements to connect.

- Vehicular access: How automobiles will reach the site is a primary consideration in any development. In addition to the connection(s) to the existing roadway network, the design of streets, the size and amount of traffic, and future connections to surrounding undeveloped property must be assessed. Depending on the development context, the developer may want to consider access to alternative forms of transportation such as transit, bicycle, and pedestrian connections.
- On-site improvement necessary for development: Essential utilities for residential development are storm drainage, sanitary sewer, water, electricity, gas, and communications (telephone, cable television). The relative cost of these facilities from one subdivision to another will vary based on the requirements, standards, and specifications of the utility service provider, whether the facilities will need to be oversized to serve development beyond the subject property, and whether site conditions require extraordinary design or construction measures to be employed.
- Title issues affecting site development: The preliminary title report is essential to the developer's site analysis. The title report provides the legal description used to delineate the legal boundaries of the property on the planning and engineering documents and is ultimately the legal basis for the new subdivision. The title report will also list encumbrances such as easements on the property that may impose physical constraints on site development. Any such encumbrances that will remain on the property post-acquisition and postdevelopment will be plotted on planning and engineering documents, prior to the new project being laid out.
- Land plan lot/unit yield: Once the project boundaries, encumbrances, topography, and significant natural features have been plotted, the land planner (land planner, architect, or civil engineer) will lay out the site based on these conditions and the project criteria provided by the developer. In some cases, these conditions may dictate the housing type to be developed. For example, a site with steep topography and/or areas of significant natural features may lead to a project where homes are clustered together in order to avoid these areas rather than a more spread out project that would require more extensive and destructive grading operations. In planning the site, the development team will consider the existing zoning ordinance and other land use regulations affecting the site; however, the development team likely will generate a plan for a project that they believe is best for the site irrespective of zoning, with the intent of seeking a change in zoning to accommodate the project. The land planning process most likely will be an iterative process based on feedback from various members of the development team.
- Entitlements necessary for development: Once the development team has arrived at a preliminary design for the project, the developer will ascertain what entitlements will be needed in order to develop the project by discussing the project with the planning department of the local agency. It is at this time that the subdivision type to be developed – standard, planned development, condominium, etc. – will be determined. At a minimum, compliance with the Map Act will be required, which usually means the processing of a tentative and final map. Other entitlements such as a rezone, specific plan amendment, general plan amendment, variance, use permit, etc. may also be required. Once the entitlements needed are determined, the developer will assess the likelihood and the timing for actually obtaining the entitlements. To the extent the developer views the entitlement process as problematic, either prior to submitting an entitlement application to the local agency or after, the developer may make changes in the project design in order to resolve any anticipated problems.
- Fees and exactions required for development: Local agencies have broad authority to impose fees and exactions on real estate development projects. For example, state law authorizes local agencies to require developers to dedicate land for parks or other public purposes as a condition to project approval. Impact fees are routinely charged to the project to mitigate the impact of new development on public facilities and

services such as parks, schools, utilities, roadways, government administration, police, fire, etc. The developer will want to accurately estimate these fees in order to create the development budget for the project.

- Title issues affecting future ownership: In addition to title matters affecting the physical development of the site, the developer will review and assess the impact of title matters that will affect future homebuyers such as the level of property taxes and assessments on the property. The type of subdivision to be developed – standard, common interest, etc. – will be determined from the project design. If the project is to be a CID, the developer will estimate the level of assessments that will be required of future homeowners. All such issues will affect the marketing of the subdivision interests.

External Factors. External factors are those that are related to the site's location, and analysis of these factors is primarily concerned with the value of the project after development, i.e., the home prices that can be achieved for the project. It is commonly understood that the value of real estate is related to its proximity to desirable (or undesirable) land uses as is indicated by the cliché, "location, location, location." For residential real estate, these locational factors include proximity to employment centers, schools and their quality, transportation, retail services, and amenities such as parks, open space and recreational facilities. The developer will assess the adequacy of these services in determining sales prices for the project. Other factors that may be detrimental to the project are its proximity to certain land uses such as industrial, agricultural, or airport facilities. Such factors may become disclosure items in the public report and/or in the developers marketing materials. Perhaps the most significant external factor to be analyzed is competition. The developer's projected sales prices will be established based on how his/her project compares to similar projects.

Land Acquisition and Land Financing

The result of the preliminary feasibility analysis and pro forma is the price and terms the developer will negotiate for the land purchase. The initial proposal often will be contained in a "letter of intent" outlining the basic business terms of the purchase and sale of the property, which may or may not be binding. Once the basic terms have been agreed to, a formal purchase and sale agreement will be prepared and signed by the parties. Purchase and sale agreements for land are similar to other real estate purchase agreements and will vary in complexity.

The typical structure of a purchase and sale agreement (or option agreement) provides the developer-buyer a certain amount of time to examine the property before committing to buy it (the feasibility period, due diligence period, or option period) and then an additional amount of time to close escrow on the property. Once a formal binding agreement has been executed, the developer has "site control," which means the seller is legally obligated to sell the property under the terms of the contract while the developer has the ability to cancel the transaction subject to the terms of the agreement. Depending on the status of the land and the land use entitlement process necessary for development, a developer will try to negotiate terms that correspond to the development process, in order to minimize his/her investment as long as possible and until the "entitlement risk" of the project has been reduced as much as possible.

There are several structural provisions and terms that are of utmost importance to the developer. These provisions are described below.

Feasibility Period. The feasibility period may also be referred to as the "due diligence" period or "option" period. Once the contract is signed, the developer will put up an earnest money deposit, usually in an escrow account, toward the purchase of the property. The purchase contract defines the feasibility period as the time from the execution of the contract to a certain date, which typically can range from 30 to 90 days or longer, depending on the nature of the property and proposed project. Like any other provision of a contract, the contract can be amended to extend the feasibility period subject to the agreement of the parties. The developer has until the expiration of the feasibility period to decide to proceed with the purchase. If the developer decides to proceed with the purchase, the deposit will become non-refundable subject to the performance of the seller's obligations under the contract. Should the developer fail to close escrow pursuant to the terms of the contract, the seller is entitled to the deposit. Should the developer decide not to purchase the property during the feasibility period, the developer will cancel the

contract and the developer is entitled to a refund of the deposit with no further obligation to the seller.

The feasibility period is a critical period for the developer to analyze all aspects of the property and its suitability for the developer's proposed use. In addition to the earnest deposit, the developer will begin incurring significant costs during this period for consultants such as architects, land planners, civil engineers, environmental engineers, soil engineers, attorneys, and market analysts.

Title Conditions. At the close of escrow, the contract will require that the seller deliver title free of all liens and encumbrances except as agreed upon by the parties. The seller will typically specify the exceptions listed on the preliminary title report that will remain on title. Because such items may affect the manner in which the property may be developed, the developer must review title matters thoroughly to determine that the project can be developed as anticipated. Note that the standard title insurance only covers the buyer for matters in the public records. If the title company failed to disclose a matter in the public records to the buyer, the title company would be potentially liable for damages incurred by the developer. However, it is possible that a significant title matter may not show up on title. For example, there may be no recorded documentation of easements, leases, or rights of others to use the property that would be evident from a physical inspection of the property. A physical inspection of the property may lead to the discovery of an access road, utility line, or encroachment such as a fence benefiting an adjacent property. An inspection also may lead to the discovery that someone is actually living on or using the property with or without permission of the owner. Rights of "squatters" or lessees such as those using the land for grazing or agricultural purposes may not show up in title records. To protect the buyer's rights against such situations, the buyer must insist that the property be vacant at the close of escrow, and the buyer will also obtain an extended coverage title policy to protect against such unrecorded matters. In order to receive this coverage, the title company will require a physical inspection and a formal detailed survey of the property.

Purchase Price and Payment of the Purchase Price. The price paid for the property can be a major factor in the success of the project. Hence, the developer's pre-acquisition due diligence should be exhaustive in analyzing and verifying the projected costs and revenues to ensure that the price is appropriate. In addition to the price, the manner in which the price is paid will be important to the developer. The terms of the purchase and sale agreement are often used as a means of risk management by the developer. The feasibility period and deposit structure described above is an example of this type of risk management. The longer the feasibility period, the lower the amount of the deposit, and the longer the escrow closing period, the lower the risk to the developer and the higher the risk to the seller. For real estate development projects, developers may seek to have closing, and even the expiration of the feasibility period, dependent upon the satisfaction of certain conditions that are critical to the developer's project, such as approval of the project by the local agency or procurement of the financing necessary for the project. The parties also may negotiate that the purchase price be paid in installments. For example, after the initial deposit and at or after the end of the feasibility period, additional non-refundable deposits may be structured and/or the seller may accept a portion of the purchase price in the form of a promissory note from the developer with payments made in specified installments after closing. Such a structure approximates an option contract structure, a traditional risk management tool, but there may be financial repercussions to the developer for a failure to perform, depending on the requirements of the contract.

In order to close escrow, the developer must have the funds available in order to complete the payment of the purchase price. If the developer does not have his/her own funds or does not wish to use his/her own funds (for risk management purposes), several sources of funding may be available. The landowner may be willing to accept payment in the form of a promissory note as mentioned above. Debt financing may be available, but the availability and favorability of the terms of such financing for unimproved land varies with market conditions. A common source of financing at the land acquisition stage is from equity investors. To raise equity investment, a developer will form a partnership with investors to acquire and develop the land. The equity investors are technically owners of the property, as opposed to lenders, but the developer typically is the manager of the partnership.

Tentative Map and Land Use Entitlements

The term "land use entitlement" refers to the development or use rights appurtenant to any property. Real estate development is subject to many federal, state, and local regulations. At the federal level, laws such as the Clean Water Act and the Endangered Species Act come into play if there are wetlands or if there is a habitat of endangered species on or near the property. The process of obtaining necessary permits to develop property subject to these laws can extend over several years.

The state of California has adopted several laws over the years affecting real estate development, but most of these laws are applied at the local level (the SLA being a notable exception). Many of these laws involve environmental regulations. In addition to the Map Act and the SLA, the CEQA and various state regulations concerning air quality and water quality must be complied with through the development process.

The most direct control of land use and development occurs at the local level because permits for development are issued by the city or county in which the project is located. Typically, conditions or provisions from state and federal laws are incorporated into approval documents by the local agency. Residential land use entitlements include but are not limited to the appropriate general plan designation, specific plan designation (if any), zoning, subdivision map, grading permit, building permit, and occupancy permit.

Land use entitlements are categorized as being either discretionary or ministerial. ***Discretionary*** entitlements are those that require judgment or deliberation when the local agency decides to approve or disapprove the entitlement. ***Ministerial*** entitlements are those that are approved by the local agency as a matter of course, so long as they comply with all applicable statutes, ordinances, or regulations by which government approval are given. Land use entitlements that require adoption or amendment of a law, such as a rezone, which is an amendment to the zoning ordinance, must be approved by the legislative body, the city council (city), or board of supervisors (county) of the local agency. Approval of non-legislative entitlements may be delegated to the planning commission or other body of the agency.

Because of governmental involvement in development, the approval process is political and can be controversial. The land use entitlement process requires several opportunities for public comment and public hearings, and decision makers tend to be responsive to public concerns. If a project is approved, it will be approved with "conditions of approval," which must be met in order for the development to proceed. Thus, from the developer's perspective, it is not enough for a project to be approved; it must also be approved with conditions acceptable to the developer. If conditions of approval make the project too costly or they cannot be met within the developer's required timeframe, the project will become infeasible. The timing of approvals varies by jurisdiction and the type, size, and complexity of individual projects. The length of the process may be further extended as a result of interaction between the developer, the local agency, and the community at large, which may lead to changes in the project itself. The application process often involves the local agency requesting additional or clarifying information from the developer, which may add to the overall schedule.

Tentative Map Process. The essential land use entitlement for a residential subdivision is approval of a "tentative map." A tentative map is a planning document specified by the Map Act, and approval of the tentative map is a discretionary entitlement. The tentative map must be approved as a first step in a two-step subdivision process delineated by the Map Act. The second step is approval of the "final map," which is a ministerial entitlement, i.e., the final map will be approved by the local agency so long as it conforms to the tentative map, the conditions of approval, and other applicable ordinances and regulations.

The tentative map shows the design of the proposed subdivision including information such as topographic conditions, street alignment and width, proposed grades, alignment and width of easements and rights-of-way for utilities, minimum lot dimensions and area, etc. In addition to the map drawing itself, the application package usually requires other supporting information such as an application form, environmental questionnaire, property photos, title information, application fees, etc.

Once the application package has been submitted to the local agency (typically the planning department), the local agency will review the application package for completeness and distribute it to various agency departments

and other agencies (utility providers, school district, etc.) for review and comment. A request will be made to the applicant for incomplete, missing, or additional information needed to complete the application.

Upon determining the application is complete, the agency conducts the analysis required by CEQA (defined on page 46) and the agency's own policies and procedures. As the application is analyzed, the local agency usually interacts with the applicant to clarify and resolve issues that may arise through the analysis. Upon completion of all analyses, the agency prepares a report recommending approval, conditional approval, or disapproval. The report, including the CEQA analysis, is then scheduled for a public hearing or hearings. Prior to taking action on the application itself, the local agency must formally certify that the CEQA analysis has been done properly. The local jurisdiction will not normally approve a tentative map unless the proposed design and improvements conform to the applicable general and specific plans, including acceptable population density, physical suitability, and health and environmental considerations. After final action is taken by the local agency, both the developer and the public may appeal the action within a specified timeframe. After the expiration of the appeal period, the application is considered approved.

Tentative map approval is a significant milestone in the development process, and is a point at which much uncertainty regarding the project has been removed. However, a tentative map expires unless a final map is approved prior to the expiration date. After the tentative map is approved, the developer will work toward final map approval by fulfilling all of the conditions of approval specified by the local agency. The most significant conditions to be fulfilled usually relate to the public improvements contemplated within the new subdivision. Prior to approval of a final map, the subdivider must design and agree to construct public improvements and dedicate land and easements to be used for public purposes. The developer must secure an agreement to make these improvements with a bond or cash deposit. Once all conditions of an approval have been fulfilled, the local jurisdiction will approve the final map. Once it is approved, it is transmitted to the County Recorder for recordation. Once recorded the legal subdivision of the property is accomplished.

Satisfaction of Conditions of Approval

Once the tentative map has been approved, the developer will proceed to work to satisfy the conditions of project approval. Such conditions will appear in the resolution(s) of the local agency approving the tentative map and other entitlements. The environmental document prepared for the project pursuant to CEQA also will contain "mitigation measures" that must be met by the project.

Typically, conditions of approval are written in such a way that they must be satisfied prior to a successive entitlement being approved. This provides the local agency sufficient power to ensure that the conditions are satisfied while the developer is still involved in the project, i.e., prior to conveying lots or units to homebuyers. Thus, the developer will satisfy conditions according to the sequence of entitlements that follow the tentative map – final map, building permit(s), and certificate(s) of occupancy. In some cases, conditions of approval and/or mitigation measures may address ownership or maintenance beyond the developer's involvement. In such cases the developer may be "forced" to develop the subdivision as a CID if he/she were not inclined to before, whereby the HOA assumes the long-term obligations imposed by the mitigation measures and/or conditions of approval.

Project Design

A project will go through a variety of changes and refinements from the time that the project is conceptualized until the time it is actually constructed. In some cases, the project may be modified after construction has begun or after units have been sold, usually in response to market conditions.

A distinction should be made between the design of the subdivision (lots and site improvements) and the design of buildings to be built on the lots. For a subdivision of single-family detached homes, the subdivision design occurs mostly independent of the home design. When designing site improvements for such subdivisions, the civil engineer will provide for utility connections and grading of home sites sufficient for typical homes to be built in the project. If the subdivision will have public streets and improvements, the standards and specifications of the local agency will dictate the design of site improvements. The design of private streets may be less restricted in many ways but it still must comply with the applicable standards of the local agency. The more dense the project and the more unique the

buildings to be built in the subdivision, the more coordinated the design effort must be between the civil engineer and the building architect. Following a critical path schedule, the developer will typically focus first on the design of site improvements since they must be approved and constructed prior to the approval of building plans and construction.

Design professionals divide the design process into three stages: schematic design, design development, and construction drawings. ***Schematic design*** is the stage at which conceptual drawings are produced, and represents the project scope, scale, and relationship of design elements to each other and to the site itself. The goal of schematic design is to work out the highest level feasibility issues of the site such as the number of units to be built, the size and massing of buildings, circulation patterns, etc. The ***design development*** stage is where the project concept is further defined with more precise details of the improvements to be built. The sizes of buildings and site improvements, the preliminary design of systems, compliance with applicable codes, etc. are worked out in this stage. The ***construction drawing*** stage is where the project concept is incorporated into technical drawings, which demonstrate compliance with all applicable codes as evidenced by the signature of the agencies responsible for administering such codes, and enables the project to be constructed according to the plans.

The tentative map submittal represents the culmination of the preliminary design process and typically would represent the equivalent of the schematic design and a portion the design development stages. Developers are averse to proceeding with design until the tentative map is approved because until that time, there remains the possibility that changes in the project design will be imposed by the local agency.

Approval of Subdivision Improvement Plans. Many of the conditions of approval apply to details of subdivision design and must be satisfied prior to the approval of a final map, which accomplishes the legal subdivision of the property. Satisfaction of these conditions is evidenced by the approval of the subdivision improvement plans, which are the construction drawings for all of the public improvements of the subdivision and/or the improvements that the local agency checks for code compliance. Typical improvement plans will show the grading of the site, the installation of "wet" utilities – storm drain, sanitary sewer, and water – street paving including sidewalks and gutters, and streetlights.

A standard condition of approval is that public improvements be constructed and dedicated to the local agency prior to the approval of the final map. Rarely does this occur in practice. Instead, the Map Act allows the developer to enter into an agreement to construct the improvements after map approval, with the agreement backed by a security instrument such as a payment and performance bond. Doing this allows the developer to proceed with the legal subdivision of the property, an important milestone in the developer's business plan, while providing the local agency a mechanism to ensure that the public improvements actually get built.

Final Map Approval and Recordation. Once the improvement plans have been approved, subdivision agreement signed, improvement security posted, and other relevant conditions have been satisfied, the local agency will schedule the approval of the final map by the legislative body. Although approval of the final map is ministerial, approval and recordation of the final map is a major milestone in the subdivision development process. Recordation of the final map creates the subdivided interests that the developer can begin marketing, subject to the requirements of the SLA. Recordation "perfects" the subdivision; i.e., the discretionary land use entitlement process has been completed, and much of the risk associated with land use entitlements has been removed from the project. The developer's construction financing will typically be tied to the recordation of the final map so that the loan will not close or be disbursed until after the final map is recorded.

Financing During the Predevelopment Stage

Predevelopment costs typically are funded from the developer's equity sources – the developer's own funds or funds from partner-investors. As the project progresses through the development process, the developer will seek financing for the development and construction stage of the process.

Development/Construction Stage

The development/construction stage is that period when the site improvements and the first homes in the subdivision are constructed and when the builder's sales program begins. Once the predevelopment stage has been

completed, the development project becomes more akin to a typical manufacturing process and it becomes subject to project management procedures similar to those used in other industries. When construction commences, the developer grades the site, installs utilities, and installs street improvements according to approved improvement plans, all the while complying with relevant conditions of approval and mitigation measures related to construction. On the construction side, the developer is primarily concerned with cost and schedule management. Ultimately, the developer wants to deliver homes just in time for the home to be sold and closed. The developer does not want to have a standing inventory of finished homes due to the carrying costs associated with such inventory. The combination of sales absorption – how fast homes sell – and the prices at which they sell relative to actual development costs, determine if the developer's primary goal of meeting or exceeding the expectations set by the project pro forma is met.

As site improvements are installed, the developer seeks to begin construction on homes as soon as possible, and locating the model home complex and the first set of production homes are key decisions.

Given the developer's critical path schedule, the developer will want to start construction on the model homes and the first phase of homes as soon as possible, simultaneous with the construction of site improvements, if possible. Homes are typically built in phases or releases of a small number of homes rather than all of the homes in the subdivision at one time, except in the case of smaller subdivisions. This helps to guard against the risk of poor sales, allows the developer to gauge other aspects of the market such as whether prices are too high or too low, and to refine design elements for future homes to be built in the subdivision. Construction lenders also typically limit the amount of funding provided for a phase of homes, requiring contracts for those homes to be signed before providing funding for additional homes.

In addition to requiring satisfaction of conditions of approval and payment of fees pertaining to building permit issuance, the local agency will typically require adequate water for fire suppression and paved emergency vehicle access to the site before it will issue the first building permit(s). In order to accommodate the developer's schedule, some local agencies will issue building permits in advance of subdivision improvement completion, particularly for model homes. However, few local agencies will grant occupancy permits, until subdivision improvements have been adequately completed.

The model home complex is an important part of the developer's marketing program, and the developer seeks to build the model home at a location with good visibility and near the most attractive features of the site. Often a new homebuyer must enter into a purchase contract prior to the home being completed or, in some cases, having been started. In such situations, the model home complex allows the buyer to better visualize and physically experience the living environment of the new home. It is the builder's best opportunity to market through effective merchandising and the utilization of professional sales people.

To the extent that no sales can occur until the final public report is obtained for the project, obtaining the report is a critical milestone in the builder's sales program and the overall project schedule. The developer is best served by beginning the application process as early as possible, immediately after filing the final map and completing the other requirements of the "minimum-filing package." The project CC&Rs should be drafted and an HOA, if any, must be formed at this time and should be formed as early as possible so as to satisfy minimum filing requirements.

In order to maximize the number of presales – the number of sales prior to construction of homes actually being completed – the developer will likely want to apply for a preliminary public report, which will allow the developer to market the subdivision and accept reservations prior to a final public report being issued.

Selling Stage

The selling stage of the development process begins with the issuance of the conditional or final public report by the DRE. The selling stage overlaps with the development/construction stage in that early marketing efforts often coincide with construction activities.

In a sense, the application requirements of the public report are a compendium of the developer's work on the project. The DRE reviews information related to the physical condition of the property, title condition, conditions