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Valuing Surplus Resort Development Land in Today's Market

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This article provides a methodology for valuing surplus land within a destination resort campus. It is important to note that the market does not recognize highly speculative development potential that is not realistic and that the following analysis only pertains to properties where there is clear potential for the value to be realized down the road.

The first decade of the 21st century experienced a level of resort development that had not been seen since the 1980s, when tax laws favored equity investment in challenging income producing properties. In the most recent development cycle of the last seven years, the "for sale" resort residential component became the economic engine that supported resort development and generated profit for the developer. Readily available, low cost financing for consumer investment in everything from timeshare intervals to wholly owned villas helped fuel the market. The demographics of the baby boomers provided a well heeled population for the many "for sale" resort products that entered the market. During the early part of the development cycle, well conceived products experienced a rapid sell-out, enabling the developer to offset many of the costs of the core resort project. As the real estate bubble popped and the country entered the economic downturn, the market for "for sale" resort residential real estate came to a halt, leaving many developers with acres of undeveloped land. During the depth of the downturn little recognition was given to the value of this surplus land. However, with an economic recovery underway, even though future development of resort land may be several years away from being financially feasible, the value of this land is once again being recognized. This article provides a methodology for valuing surplus land within a destination resort campus.

Valuing Surplus Land

Since many of these vacant tracts of land are located within resort campuses, they typically have no independent access routes and thus have little utility to anyone other than the resort's current owner. Therefore, these parcels are typically not separable from the resort campus rendering the sales comparison approach not a useful method in valuing the land. Furthermore, with limited vacant land sales throughout the nation since the start of the credit crisis, a sales comparison approach value based on dated comparable sales or land sales from a different geographic area may yield a less than credible result.

Without the sales comparison approach,

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the appraiser looks to the land residual technique to value resort vacant land with future development potential. The Dictionary of Real Estate Appraisal defines the land residual technique as "A method of estimating land value in which the net operating income attributable to the land is capitalized to produce an indication of the land's contribution to the total property."[1] During the previous economic cycle, when for-sale resort residential real estate was selling at premium pricing and when inventories would pre-sell in a matter of hours, performing the land residual technique was a straightforward exercise that typically yielded a robust value. Based on a planned development program, a sellout of whole-ownership residential, hotel condominium, or fractional improvements was forecast. Construction, sales costs and a developer's profit were estimated and deducted, and the net sales proceeds were discounted at a market rate of return and summed to derive the residual value to the land.

Beginning in early 2008, when completing this type of analysis, the credit crisis, the nation's residential real estate woes, the recent economic recession, and the inability to find construction financing rendered this analysis inappropriate. Unit sales had halted and prices had declined to such an extent that a residual approach yielded no value to the land. The development horizon was considered too many years in the future to even hypothesize when unit sales could once again generate a profit. Starting in the third quarter of 2010, resort owners and developers began looking once again at resort vacant land as having some value. Based on our recent experience in valuing resorts and our discussions with owners and lenders, there is still a lack of construction financing available and robust consumer demand for residential products as part of a resort have yet to return; however, there appears to be light at the end of the tunnel and the expectation is that construction financing will return to the marketplace sometime in the next two years, and as the domestic economy improves, demand for these residential products will rebound—albeit at lower than previous peak pricing. Nonetheless, with a development horizon still multiple years in the future, resort owners and prospective purchasers are beginning to look at their assets' development potential again with the expectation of yielding a positive land residual value.

In order for the land residual technique to yield a reliable value indication in today's economic climate, it is important that the inputs be realistic and reflect the reality of the current marketplace that is typically characterized by longer residential sell-out periods, lower pricing, and higher discount rates than were achieved in the last upcycle. The following tables present a sample land residual calculation. The first table outlines the development program and assumptions, while the second table presents the calculation of the land residual value.

Assumptions

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Example 1 – Land Residual Calculation Using Sales Price and Pace Forecast

		2014	2015	2016	2017
Number of Units		30	25	20	15
Square Footage/Unit		1,300	1,300	1,300	1,300
Total Square Footage		39,000	32,500	26,000	19,500
Price/SF		$700	$700	$700	$700
Price Increase		---	0%	0%	0%
Sales Revenue		$27,300,000	$22,750,000	$18,200,000	$13,650,000
less: Construction Costs/SF	$500	19,500,000	16,250,000	13,000,000	9,750,000
less: Sales & Marketing Costs	10%	2,730,000	2,275,000	1,820,000	1,365,000
Sales Proceeds		$5,070,000	$4,225,000	$3,380,000	$2,535,000
Market Value					
Discount Factor	30%	0.3501	0.2693	0.2072	0.1594
Present Value		$1,775,148	$1,137,915	$700,256	$403,994
Value - January 1, 2011		$4,017,312			
Say		**$4,000,000**			
Per Building Square Foot		**$34.19**			
Per Unit		**$44,444**			

The previously detailed land residual calculation encompassed the following steps:

- The development program is typically set by the developer/owner and designates the number of units, unit size, and the construction schedule.
- Determining the sales price and pace is the most important assumption/input that goes into the land residual calculation. The sales price forecast should be based on comparable sales, with positive or negative adjustments made for the subject development based on quality of construction, unit size, and availability of recreational facilities and hotel amenities. In markets that have low amounts of inventory that is currently for sale and prices did not decline dramatically, development will resume earlier than in markets that got overbuilt and prices collapsed during the previous economic cycle. It is important to note that the land residual method is likely not applicable in markets where it will take many years to absorb existing inventory, but in many markets the supply/demand equation is more favorable, and thus development can be foreseen within a reasonable time horizon. The example above did not include any price increases over the sellout period. These can be factored into the analysis if warranted, i.e. there is strong enough demand in place that would allow the developer to increase prices later in the sellout period.
- Construction costs are also designated by the developer/owner. According to our discussions with owners and developers, construction material costs have not declined substantially in the recent economic recession; however, contractors have gotten much more aggressive when trying to win jobs, which have brought down labor costs and contrac-

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tor profit margins. Note that in the land residual approach the construction cost estimate should be exclusive of land acquisition costs.

- Sales and marketing costs can be estimated by a professional real estate brokerage, sales or marketing organization that specializes in marketing for sale resort real estate projects. These companies can help define potential purchasers and tailor and execute a sales strategy. It makes sense to choose the marketing company early in the development process as they can provide valuable input into the development program and help ensure that the program matches the target market.

- The sales proceeds (sales revenue less construction costs and sales and marketing costs) are discounted to today's (2011) dollars at an appropriate discount rate. On first glance, the 30% used in our example may seem high; however, is within the range of discount rates for such analysis during the peak of the previous economic cycle, where 25% to 40% was the norm. This discount rate is intended to include the developer's profit. Historically profit was deducted as a separate expense, but in the most recent development cycle we have seen the market back away from this approach and build profit into the overall yield of the project, as reflected in the discount rate. In undertaking any development, there has to be some economic incentive for the developer, unless it is a non-profit project or being completed "pro-bono." This economic incentive is built into this discount rate.

If a reliable estimate of unit pricing is unavailable or sales pace is too hard to predict, yet you are sure that there may be value in your resort vacant land, the above analysis could be simplified. If a previous comparable whole-ownership project that a developer completed yielded a profit per unit of say $170,000 (same profit as generated in the previous example), after all costs were deducted, and you expected that the same profit could be obtained on a future project once demand returns, the following analysis to determine land value could be completed.

Example 2 – Land Residual Calculation Using Unit Profit Forecast

		2014	2015	2016	2017
Number of Units		30	25	20	15
Profit per Unit		$170,000	$170,000	$170,000	$170,000
Profit Proceeds		5,100,000	4,250,000	3,400,000	2,550,000
Market Value					
Discount Factor	30%	0.3501	0.2693	0.2072	0.1594
Present Value		$1,785,652	$1,144,649	$704,399	$406,384
Value - January 1, 2011		$4,041,084			
Say		**$4,000,000**			
Per Building Square Foot		**$34.19**			
Per Unit		**$44,444**			

As shown, the concluded land value per square foot in each example is comparable. Even though these examples have been simplified, based on assignments that we

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have completed over the past six months and discussions with lenders, resort owners, and developers, this approach is considered reasonable and reflective of today's marketplace. It is important to note that the best way to accurately determine important variables such as sales price and pace is through a comprehensive market and financial feasibility study, either performed in-house or with outside expertise.

Conclusion

Only time will tell how long it will take for the market for "for sale" resort residential real estate to resume. Valuing surplus resort land is a project by project, market by market exercise that must be undertaken with due consideration and the extra value would only be in instances where the market is recognizing the value and the potential use is apparent. The value of this key component of many resorts deserves to once again be recognized.

NOTES:

[1]Appraisal Institute. The Dictionary of Real Estate Appraisal 5th ed. Chicago: Author, 2010, p. 109.

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