TALES FROM THE TRENCHES™
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REAL ESTATE DEVELOPMENT IS A SENIOR STRATEGY

The bedrock strategy of the Real Estate Investment Network (REIN) is buy-and-hold. That's what we teach and that's what most investors employ as their main strategy. We think it takes purchasing at least three buy-and-hold properties to give anyone a basic understanding of this most straightforward of strategies.

Once you start moving up to multifamily there are other wrinkles and crinkles as you work your way through the duplex, fourplex, sixplex scenarios and then into the 20-suiter (or bigger!) apartment buildings. The strategies for multifamily purchases are a little more complex. But, and this is a big but, moving from any of these strategies into what we call "development" is a totally different kettle of fish. Investors who insisted that experience and success with buy-and-hold strategies prepared them to be developers have lived both to regret that notion and the accompanying huge monetary losses. Let's look at some examples.

Our first investor found a piece of property near a major Alberta city and felt that the property would make good acreage subdivision. He had a partner with a fleet of earthmoving equipment and lots of experience. He negotiated with the relatively unsophisticated owner subject to financing, permitting, and subdivision requirements. Many condition dates came and went without conditions being removed. Still, the seller and our investor stumbled along.

The transaction eventually went unconditional, but ultimately failed when our investor could not satisfy his lender's tough requirements for project advances on the mortgage.

Our investor failed to properly assess or understand:

1. The difficulty of working with a municipality to get a Development Agreement
2. The length of time it takes to work with the utility providers
3. The cost of installing utilities and services
4. The length of time it would take to accomplish the numerous aspects of a major subdivision development
5. His ability to convince a lender that millions of dollars should be advanced because our investor thought things would work out

This investor believed, wrongly, that

1. His expertise as a real estate investor with slightly more than rookie experience
2. His partner's fleet of earth moving equipment would overcome any of the difficulties

He was wrong and his company is bankrupt.

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Our second investor invested in the debentures (promises to pay secured by company assets) of a development company doing a residential development in a small, southern Alberta town. The debenture was issued by way of prospectus and properly done through the securities commission.

The developer badly underestimated the attractiveness of his project and kept running out of money. Presales were not good. The developer kept returning to the debenture holders asking them to postpone their first security interest to new money from other lenders. The developer finally washed his hands of the project and the debenture holders have had numerous committee meetings to see how they can try and preserve their investment.

It was difficult if not impossible for the debenture holders to analyze whether the developers had a chance of success with his project. It appears that our investor and other debenture holders relied on Alberta's boom in an attractive area to assure themselves that the project would move to completion. They were wrong and our investor is holding the bag along with other debenture holders.

They may never be paid or at pennies on the dollar.

Our third investors were a husband and wife team with very high paying jobs in Alberta's oil patch. They met a developer who had moved to Alberta from another province and started on numerous Alberta real estate developments. For due diligence, our investor checked in the developer's home province and found the developer was well thought of, with lots of experience.

Our investors put up $200,000 for a hazy, unsecured interest in one of a number of developments and a promise of large profits. The developer insisted the investment would be hands off with our investors having no say. Our investors subsequently noted that the developer was short staffed and undercapitalized for the projects. Later on, it was discovered that the developer was mixing funds from various investors in various projects.
Our investors are now embroiled in a court battle looking to retrieve their $200,000.

Our fourth investor wanted to graduate from buy-and-hold and morph into being a builder/developer. The plan was to purchase a lot and build a fourplex. He found a lot zoned for a duplex in an area full of duplexes and fourplexes. He understood that he couldn't build a fourplex, but thought that was just a matter of getting a variance from the city planning and building department. The street already had some fourplexes didn't it? So, the lot was bought, and the deal went unconditional.

What our investor didn't understand was that unless the zoning allowed a fourplex as either a permitted or a discretionary use, a development officer has no authority to issue a permit; s/he has no authority to change the use. The word variance applies to the development regulations that apply to a particular zone. In other words if the zoning allows a fourplex but requires a certain side yard, then, if your side yard is deficient, the development officer can give you a variance with respect to the side yard. But, s/he still can't change the use.

Our investor overpaid for the lot, and so he will now have to build a duplex and hope to break even, or sell the lot and take a loss.

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Lessons Learned:

1. Whether you are the developer or purchasing securities related to a development, real estate development is a very tough game, with hugely different rules, and a long apprenticeship. Examples one and four illustrate the difficulties developers face.

2. If purchasing a single family home or condo townhouse is the 1st level of real estate investing, multi-family buildings are the 2nd level, and anything to do with real estate development is at least the 3rd and probably the 4th plane of difficulty.

3. In our second and third examples, our investors were promised or felt there were very high financial returns, but they had no idea of the risk. Folks, there is a reason for high returns, ***you have high risk***!! You simply cannot put money into any facet of real estate development without a real hard risk assessment, a ton of experience, and/or expert professional advice.