Using Land / Building Equity to Maximize HUD Construction / Rehab Financing

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What is Land / Building Equity?

Land equity is the difference in current land value (or building to be rehabbed value) beyond the outstanding debt.

For example: A parcel of land was purchased 10 years ago for $100,000. That parcel is now worth $1,000,000 with no debt associated.

That $900,000 in value can be recognized by HUD to reduce your cash out of pocket in some scenarios.

How does it work?

- One of the criteria HUD uses to determine the mortgage amount for construction and rehab is **replacement cost**.

- The replacement cost = Construction costs plus land or building value.

- *Example:*
- A project has construction costs of $21,473,620.
- The land value is $3,000,000.
- The replacement cost = $24,473,629 (the above two figures combined).

How does it work? (con’t)

- The replacement cost is then multiplied by 85% as one of HUD’s mortgage amount calculations: (85% x 24,473,629 = **$20,802,585).**

- With total construction costs are $21,473,629, the cash out of pocket is $21,473,629 - $20,802,585 = **$671,629.**

- *In reality, non-mortgageable escrows would be needed in addition to this amount, but this is for demonstrative purposes. Also the 85% figure can increase for affordable projects.*

What's the impact?

- If we reduced the land value from $3,000,000 to $1,000,000, our equity required would increase from $671,629 to $2,357,232.
- Essentially we have the same construction budget in either scenario, but qualify for a lower mortgage based on replacement cost if the land (or building) value is lower.
- The lower the mortgage, the larger cash contribution from the developer.

- $3mm in land value:

Total Estimate Replacement Cost of Project (from G-47)	$24,473,629
85%	85%
Maximum Mortgage based on Replacement Costs	**$20,802,585**

- $1mm in land value:

Total Estimate Replacement Cost of Project (from G-47)	$22,380,232
85%	85%
Maximum Mortgage based on Replacement Costs	**$19,023,197**

Things to Know

We're often asked if this benefit can be achieved with recently purchased sites or buildings.

For example, if you buy a piece of dirt and get it shovel ready (permitting, etc), it is going to be worth more than when you bought it? It's possible, but heavily depends on market, and it is likely the appraiser will include the recent purchase as a comparable in determining the value.

For existing structures, equity is based on the contributory value of the as-is structure and land to the proposed project. For example, old FF&E would be irrelevant to the proposed project so it should be excluded from the value, however the land, building shell, and infrastructure are likely contributory, which offers the same dynamic as land.

Put Simply

Fundamentally this is a “paper” credit. You’re essentially mortgaging your own equity reduction by including a mortgaged “cost” in the transaction with a value that does not have an equivalent debt.

In Closing

- The benefits vary from project to project, and *may not* help in some circumstances (particularly projects with very high costs or low income), but contributing land equity *can* have a *significant* impact on ROI.
- We have seen some projects where the land equity is all the “cash” needed at closing.
- In some cases, if the value is exceedingly high, you may be in a situation where you’re essentially getting cash back for constructing a property!