

FINANCING Spec Homes

When a builder asks how to get started in spec home construction, he or she is often told

by Sam Morgan

that it's not enough to have the equipment and the skills: You've got to have the cash.

Well, I know a lot of spec builders, and except for the really big outfits, I don't know any who build spec houses with their own money. For the smaller contractor, it only makes sense to build with someone else's money. You have to know how to manage that money, but you don't have to supply it — and there are several ways to get started.

I've been building a mix of spec and custom homes in Utah for about six years, focusing on the move-up market. For my area, that's the \$275,000 to \$400,000 range. I've financed my spec houses in a number of different ways, but I've never had to supply more cash than the earnest money for the building lot.

For me, spec houses are a means to an end. It's hard to get a custom home contract if you can't show customers homes that you've built; so when I first got started, I built several spec homes on a cul-de-sac just to have a product I could show. Nowadays, I'm building about half spec and half custom.

I'd like to do all custom work, but I'm not there yet. The spec houses keep us busy when we don't have a custom job going, and I tend to make a little better profit on spec houses than on my custom jobs.



In this article, I'll explain the different methods I've used to get construction loans. Then I'll discuss what I've learned about how to build houses that will sell quickly for a decent profit.

Bank Financing

There are banks everywhere that are willing to finance construction. When it comes to interest rates, fees, and the ratios they'll allow, one bank is about the same as another in my experience. But not all banks are interested in spec home lending, so you may have to shop around for a bank to work with.

The best luck I've had with banks is with one that came through a referral from a friend who's a mortgage broker. He actually referred me to a particular loan officer who he said would help me arrange a construction loan secured in part by equity in my existing home. The loan officer explained

exactly what I needed to do and walked me through the first application. Once we got to know each other, it became routine.

That loan officer has since switched companies three times, and I've followed him to his new bank each time. I'm now doing loans with his new employer just because I know that particular officer, he knows me, and he's familiar with the way we put our packages together.

When you're getting started in a banking relationship, you'll have to supply a lot of documentation. They'll need a set of plans and a detailed cost breakdown on the project, and either they'll ask you to provide an appraisal, or they'll have one done themselves and charge you for it.

They'll also need information on you and your business. The more documentation you provide, the more

warm and fuzzy they're going to feel. You'll have to provide a copy of your license and insurance coverages. They're also going to want to look at current financial statements for you and for your business. It's best to have those prepared by an accountant.

I work closely with my accountant anyway. So I'm always able to send a bank current balance sheets and income statements showing my numbers for the month and the year to date. That all has to be solid if you want a bank to back your projects.

The main thing banks care about is that the loan is secure. They want to be certain that they are going to get their money back. Typically, loan officers go by a formula. The banks I deal with in my area will lend me all the money I want for spec homes, as long as what I'm asking for doesn't exceed 80% of the home's appraised value and 90% of hard costs.

One key element is to get a favorable appraisal. It helps me a lot that I have found an appraiser who consistently gives high values on homes. My appraiser is realistic, but he goes the extra mile to find good comparables.

Here's an example of why a good appraisal matters: I just sold a spec house that was first appraised for \$285,000 from the plans. We had two more appraisals done before the highest one came in at \$305,000 — and even that was conservative, since the house actually went for \$325,000. But based on 80% of appraised value, a bank would be willing to loan only \$228,000 on the lowest appraisal, compared to \$244,000 on the highest one. The \$16,000 difference could make or break a project, especially if a builder's trying to provide it out of his own pocket.

Hard costs are the other piece of the puzzle. I always give the bank and the appraiser a detailed cost breakdown that includes materials, labor, and land. Based on 90% of hard costs, a bank would lend \$244,000 for a project I could build for \$271,000 (land

included). That leaves \$27,000 that has to come from somewhere else. If you don't have the cash lying around, what can you do?

One way to get your actual hard costs down closer to your loan amount is to hold off on certain expenditures, such as carpets and appliances. The buyer usually will want to choose those anyway; if you don't purchase them until you have a buyer, you can roll their cost into the buyer's long-term financing, or pay for them out of the buyer's cash down payment.

But even without buying those last-minute options, you may not have quite enough to get the house built. If you don't have the cash to cover the difference, you need another source of funds. I've used several different strategies to bridge the gap, each of which has its pros and cons.

Using Equity in Your Home

The method I used to get started pretty much limits you to building one spec house at a time, and you have to own your own house and have equity built up in it. Of course, you also need to have a good credit history.

Here's the technique: I simply tell the bank that I'm building a new home for myself and will be selling my current home during construction. As long as I have a long-term approval letter (easy to get from any mortgage lender) and allow the bank to file a lien on my current home, I have never had a problem getting a construction loan this way.

For a regular spec-house construction loan, banks will usually allow you only 70% of the appraisal. But when you present yourself as the buyer, the bank sees the home as pre-sold just like a custom home. Your existing home is already finished and can be reliably appraised. So they'll loan as much as 80% of the combined value of the new house's appraised value and the equity in the existing house. By staking the equity in your current

home, you can borrow enough to build the new one. And in reality, the bank doesn't care whether you move into the house or sell it when it's finished — they just want to be repaid at the end of the loan period.

The drawback to this whole system is that you'll only get financing to build a house that you can afford to live in yourself. In other words, what you can build depends on what you can buy. That may not be the price range that is selling best in your market, or the price range that will bring you the best profit. And, of course, the equity in your home is an important asset, and you shouldn't take too big a risk with it.

I've had mixed results with this technique. The first home I built this way, I sold before the drywall was on and made about \$20,000 in addition to the wages I drew during construction. The next one I built didn't have a really attractive design and didn't sell quickly, so I actually ended up moving into it. On the other hand, I made \$30,000 when I sold it and moved out a couple of years later, and I learned something about the importance of curb appeal. (By the way, you pay no capital gains tax if you sell a house you're living in.) My third house I sold during framing for about \$18,000 profit; I could have made more if I had waited until it was finished, but I had two homes going at the same time, and I wanted the security of a sale then more than the opportunity of a better price later.

Using a Partner's Home Equity

A variation of the method I've just explained is to build a spec home with a partner who is willing to do what I did — take out a construction loan as the home buyer and back it with equity in his existing house. I've built that way with a partner several times; one house did sell, but another two we finished up at a time when the market was slow and interest rates were high, and my partners ended up

Making the Numbers Work

Once the bank is on board the project, the additional funds you need to line up aren't much compared to the profit you stand to make. To put things in perspective, here are some numbers drawn from a house I'm about to start. I'm reasonably confident of all these figures, because this house is almost identical to one I built last year.

Basic Numbers

Sales price target:	\$305,000
Appraised value:	\$310,000
Lot purchase price:	\$77,900
Construction cost:	\$175,000
Loan cost (fees and interest):	\$10,000
Contingency allowance for realtor's fee:	\$16,000
Total project costs:	\$278,900
Expected profit minus closing costs (selling through realtor):	\$26,100
Expected profit minus closing costs (selling without realtor):	\$42,100

The house appraises for \$310,000. My asking price on the house will be \$305,000, and the lot will cost me \$77,900. Construction costs are going to be right around \$175,000 (that includes about \$6,000 for overhead items like signs and advertising), and my loan costs (interest and fees) will come in at just about \$10,000. My cost projection also includes a \$16,000 allowance for a realtor's commission, just in case I need a realtor to sell the home. All together, I'll be laying out \$278,900.

If I sell the house at full price and pay a realtor, I will make \$26,100 (minus any closing costs). If I sell it on my own, I can make an additional \$16,000, for a \$42,100 total profit. I will also have my own crew do the framing, soffit, tile, trim, some grading of the lot, and the deck construction; I look to earn about another \$10,000 from my draws against that construction work, after paying out labor.

The Spread

Total project costs:	\$278,900
Loan amount:	\$248,000
Cash needed above loan amount:	\$30,900
Deferred construction expenses:	\$9,000
Deferred realtor's fee:	\$16,000
Builder's cash or equity assets or partner's equity assets:	\$5,000

Based on the appraisal and my cost breakdown, the bank will be willing to lend me \$248,000 of my \$278,900 project costs. That leaves me \$30,900 to come up with, either from my own money or from one of the other sources I've described. But I plan to go through the cost breakdown and find items that don't have to be put in until I have a buyer. I won't have to pay a realtor until closing, for one thing, so that \$16,000 is deferred until the very end. I won't put in the air-conditioning unit, the carpeting, or the appliances until I have a buyer. For this house, those items add up to about \$9,000, which I can readily float with short-term vendor credit.

Now we're short only about \$5,000 on paper. At this point, if I didn't have a subordination deal on the land, I could do one of the following: come up with the \$5,000 in cash, use equity in my home that the bank would take a lien position on, forgo some of my own income briefly, cut the overhead expenses, or just shave some building costs. My preference is usually to shave some of the cost on the house. For instance, I'm planning some nice finish work and two-tone paint in this home; going with one-tone paint and a more basic trim package could save about \$1,500 to \$2,000. Then I just plan to up-sell the buyers if we haven't done trim or paint by the time the house sells. Of course, if we get a buyer before we're done — which often happens when the market is active — we may end up selling quite a few extras, for some additional income.

moving into the houses themselves.

I didn't make much on those projects — I earned my wages during construction, but there were no real profits to split. My agreement with my partners didn't have any provision for me to be paid a management fee if they decided to move into the homes themselves. That was a rookie mistake — if I had it to do again, I'd have a contract that included a builder's fee for me in that event.

My partners had an initial disappointment when they had to move into the homes instead of raking in a nice profit. But we won't know the end of the story until they sell again — they'll probably make out well in the long run. And if nothing else, at least I have three more houses to show.

Subordination From the Landowner

Another way to create the required spread between your bank loan and the appraised value is to get some help from the lot owner. Lot sellers are often willing to get paid a portion of their money up front and the rest when you sell the house. If you can get the person selling you the land to subordinate part of the purchase price (20% is pretty reasonable), so that the bank isn't paying for all of the lot, it will be easier to arrange the rest of the financing.

"Subordination" of a loan means that in the event of a foreclosure or sale, the lender is second in line for repayment. If the house was foreclosed, the bank would be repaid in full before the lot owner got any more money. On the other hand, this only applies to part of the lot price — the landowner gets cash for most of it.

A subordination agreement was part of the deal for two of the first three spec homes I built. The lots were priced at \$60,000, and the seller subordinated \$10,000. Typically, the seller just wants to be paid interest and have a lien on the property until he's repaid. In effect, you're getting a small loan from the lot owner. I typi-

cally have had to pay the lot seller about 10% in interest.

Working With a Developer

I've seen lot subordination from both sides. In addition to being a builder, I've recently joined with several partners to become a developer. We've bought several parcels of land, subdivided them, made improvements, and now we're selling lots. We build houses ourselves on some of the lots, but we're happy to sell to another builder, or to a home buyer who's using another builder for a custom project.

Sometimes the buyer has asked us to do subordination. We don't like to do it, because if the deal goes south we'll be the last to get paid. But on the other hand, we're selling lots for \$70,000 that cost us just \$45,000 apiece to buy and develop; even if the builder defaulted on a \$15,000 subordination, we'd still make some profit. So we've agreed to subordination a couple of times. When we do, however, we take steps to limit our risk and avoid extra costs: Either we ask for a letter from the bank guaranteeing that we'll get paid, or we charge a high interest rate to encourage the buyer to pay us off quickly.

The reason we'll do it at all is that there's an advantage to us in moving these properties, especially at the beginning of a project. I started two spec homes last fall that I might not have started in a slow market, except that they're in my own subdivisions. We're trying to sell lots, and we have to get something built in there so we can get people to come in and get excited.

It can be hard to sell the first few lots, because people don't want to be first. No one wants to come into a subdivision and build a \$400,000 home and then have two dozen other homes come in that are worth only \$200,000. So we typically go into our own subdivisions and build the first few homes, whether they're spec or custom homes, just to set the tone for

the subdivision. And we're eager to have other builders do the same.

That same logic can help you when you're trying to finance a spec house. Go to a brand-new development and tell the developer, "I want to build on a few of your lots, but in order to get the financing, I can only pay part of the lot price in advance. I need you to subordinate the rest." That's attractive to developers if they don't want to build most of the homes themselves. Some developers will take half down and wait for the rest if that's what it takes to get homes built. On the other hand, you'll probably be charged full price or even a slight premium for the lot.

Once you're in with the developers, there's no good reason they shouldn't let you build on several lots at a time and pay for the land when the homes sell. That will make the bank happy and keep things moving along for everyone.

Private Investors

Currently, I am financing all my specs through a private investor I was lucky enough to meet through a mutual friend. This investor has financed two of our subdivisions, and he is also providing the construction loans on any homes I want to build.

He charges me a little more interest than the banks do but a smaller origination fee to do the loan. The best thing is that there's no documentation. I call him up and tell him what I need, and he sends me a deed of trust to sign — that's it. No hassle: One phone call and two faxes, and I'm ready to go.

For him, it makes a lot of sense. He's already financing the developments, and in the slow market we've been having, we're not moving many lots right at the moment. If we keep building houses and moving them, he keeps making money.

It was just luck that I made this connection, but it's not all that unusual. There are a million and a half millionaires in the U.S., and a lot of them invest privately in enterprises,

whether as equity investors, as lenders, or as partners. Home building and developing aren't sure things, but neither is the stock market. And with a spec house, there's a hard asset securing the loan. Your investor can drive over and look at the project any time he wants — that's why they call it "real" estate.

Not everyone is going to find a private money man to back a business, but it's worth looking into. If this person decided to get out of our business, I could probably find someone else. For example, I got some leads on investors from my contact at a title company — title companies seem to know lots of affluent people who like to invest in real estate.

Homes That Sell

Of course, when you don't have a custom client, building a house is taking a risk. For success, you need to do whatever you can to increase the odds that the house will sell quickly. It's extremely important to find the best location and choose the best price range.

Location matters most. Don't ever buy a cheap lot in a bad location — the nicest house in an unattractive area won't move anywhere near as well as the mid-range house in an attractive area. Instead, build in premium subdivisions where a lot of building is going on. Build where customers want to live.

I look for cul-de-sacs or dead ends in nice, quiet little areas, where there's not much street traffic. You don't see a lot of passersby in those places, so you have to bring buyers in, but most home buyers seem to prefer to avoid busy streets.

You should also pick a price range where homes tend to sell fast. Here in Utah, starter homes go for \$125,000 to \$150,000. The average home is probably a bit over \$200,000. Personally, I don't build any specs priced under \$275,000, and most of my specs have sold before being drywalled.

I don't have any scientific informa-

tion to base that price target on. But just scanning the for-sale ads around here, I see many homes for sale in the high 100s and low 200s. A builder might do a spec in that price range because he could afford it himself, but he would be competing with dozens of other builders doing the same thing. Over \$250,000, it really thins out, at least around here, so I figure that's the range where I'll get more exposure.

Also, as I said, I'm building specs partly to have homes to show my custom clients. I want to build custom homes in the \$400,000 range and up, so that's the market I target with my specs. Other builders sometimes ask me how I keep landing \$400,000 and \$500,000 custom jobs; well, I tell them, those are the kinds of homes I have to show people.



The other key factor for selling spec homes is appearance. The one house I built that was slow to sell was really my own fault — it had a nice, practical floor plan and was in a good spot, but it had a really boring, unattractive front elevation. The one I built next door had almost the same floor plan but a nicer front, and it sold before the framing was done. What I learned is that it's better to spend the money for a designer to create a really pleasant front elevation — a house with good curb appeal — than to spend it anywhere else. Regardless of how many nice features you build into the house, if it doesn't look good from the street, it won't sell quickly.

Land, Building Costs, and Profits

In the locations I'm choosing, lot prices end up being a large portion of my cost. At our state builder's association seminars this spring, a speaker told us that you have to keep your lot cost at about 25% of the total project cost. My experience bears that out in general. Most of the lots we're building on start at about \$75,000. For example, the client of a custom home I'm building right now paid about \$77,000 for the lot, and we're trying to limit the cost of the house to about \$320,000. So the lot amounts to about a quarter of the total. That's pretty typical for me, but because I target the high end, I sometimes pay a premium for a lot in a prime location.

I make money on lots I develop. But when I build on someone else's lot, I don't expect to make money on the land. I'm paying for nice and fairly pricey lots in order to have a project that will sell quickly; and I'm aiming to make my profit on the house.

On projects that sell for right around \$300,000, I'm happy with a profit of about \$20,000, though I'd prefer \$30,000. Taking the lot out of the picture, that's maybe a 10% to 15% profit on just the construction. However, I also pay myself and my crew wages for the work we do, along with my usual overhead and construction management fee. That's part of my cost breakdown, and it comes out of my draws. However, the bank or other financier always knows that I won't take any profit on a job until the home actually sells.

Considering my own wages and the profit together, I stand to make about \$30,000 all total on each spec project. When it's on a lot we developed, there's another \$5,000 or so for me as my share in the profits from the lot. I'm not looking to make a killing on one house, but if I can do three or four successful specs a year, I'll have a good income.



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