

Saskatoon Land

Procedure #7 Risk Assessment

May 23, 2017

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Scope of Work

PwC was retained by the City of Saskatoon to perform certain procedures relating to a review of the City's Land Division (Saskatoon Land).

Scope of Mandate

- The overall scope of the engagement consists of a number of specific items including:
 - Assessing whether the City of Saskatoon's Land Division ("Saskatoon Land") is adhering to certain policies regarding the administration of lot draws, over the counter sales, maintenance of the Eligible Builders' List and adherence to the time frames surrounding lot purchases and construction timelines;
 - Analyzing Conflict of Interest Guidelines to assess whether adequate safe guards exist;
 - Analyzing lot prices and the lot pricing process to assess whether Saskatoon Land is competitive and responding to the market;
 - Analyzing land policies and procedures to assess whether they are equitable;
 - Analyzing the Privacy and Access to Information utilized to assess whether information that should be made public is being made public;
 - Analyzing the current business and governance structure; and
 - Conducting a risk assessment of the operations of Saskatoon Land to assess whether investments are timely and do not overexpose the citizens of Saskatoon to unnecessary investment risk.
- The purpose of this portion of the Report is to provide commentary on Saskatoon Land's operations to evaluate whether investments are timely and do not overexpose the City to unnecessary investment risk.

Procedures Performed

- Analyzed background information describing Saskatoon Land and its operations, including its corporate mandate, current land holdings, historic transaction activity, operating policies and procedures, approval processes and regulations.
- Conducted interviews with Saskatoon Land to better understand its real estate activities, policies, reporting and approval processes.
- Reviewed information describing the relationship between Saskatoon Land and the City's Land Development business.
- Travelled to a subset of properties owned by Saskatoon Land to view a portion of the portfolio.
- Reviewed information detailing total returns.
- Conducted research to assess comparable returns, including comparable returns realized by other municipal land corporations/entities and private sector developers.

Background

Saskatoon Land was established in 1954, formalizing the City's involvement in the land development business and actively acquiring land for future development.

History

- The City of Saskatoon has been active in the business of developing and selling land since the 1920s, at a time when numerous properties were obtained through tax enforcement.
- In 1954 the City formalized its involvement in the land development business by actively acquiring land for future development. This land-banking function was unique among municipalities and is noted as being one of the more extensive operations of its kind.
- Since the 1950s, the City, through Saskatoon Land, has played a significant role in developing Saskatoon communities, and more recently, supplying serviced industrial land to accommodate growth.
- Per its Annual Report, Saskatoon Land (Asset and Financial Management Department) supports the building of innovative communities which provide valued amenities, enhanced quality of life, community identity, and lasting value to the investors and families that choose Saskatoon Land developments.
- providing financial returns at competitive rates of return on investment to the City for allocation to civic projects and programs;
- coordinating and overseeing the ongoing maintenance and leasing of all City-owned future development lands; and
- operating on a level playing field with other land development interests in the city.

Operations

- Saskatoon Land is comprised of 18 staff members.
- In developing land and offering it for sale, Saskatoon Land staff undertake the following tasks:
 - examine the demand for institutional, commercial, industrial and residential land; and
 - arrange for the appropriate quantity and type of land to be designed and developed for eventual sale based on market assessments.
- In servicing land, Saskatoon Land works with staff at the Saskatoon Water and Construction and Design Divisions within the Transportation and Utilities Department who provide engineering design, drafting and project management during the servicing phase of the land development process.
- While a municipal department, Saskatoon Land is mandated to operate on a level playing field with other private sector developers, and is subject to the same procedures and regulations that govern the land development process within the City.

Saskatoon Land operates pursuant to a number of Council Policies which outline how it conducts its business. In addition, Saskatoon Land also undertakes additional processes, including market due diligence, to report on its operations.

Council Policies

- Saskatoon Land operates pursuant to a number of Council Policies which govern how it conducts its business. Such Policies include:
 - **C09-001** which details how Saskatoon Land will foster competition and diversity in the home building industry to ensure a fair and equitable allocation of City-owned lots to contractors;
 - **C09-006** which details how Saskatoon Land is to market City-owned residential lots to contractors and individuals;
 - **C09-009** which outlines the incentives program for industrial land to assist in attracting new industry to the city and to encourage the expansion of existing industries;
 - **C09-010** which details how the City may provide financial incentives to assist residential homebuilders construct and operate show homes on property made available through the City's Land Bank;
 - **C09-015** which details how the City may pay real estate commissions on the sale of City-owned industrial, commercial and institutional land; and
 - **C09-033** which details various guidelines relating to the sale and/or requests to purchase/lease City-owned land.
- These policies, among others, serve to outline the guidelines under which Saskatoon Land operates as well as the process through which lands will be sold or leased, and who is eligible to purchase/lease those lands.

Additional Processes

- In addition to adhering to a number of Council Policies, Saskatoon Land also undertakes additional processes designed to provide market intelligence and guidance on its business operations, including:
 - it tracks serviced residential land and lot inventories to provide it with insight and intel on future supply;
 - it completes an annual builder survey to obtain insight on development trends;
 - it liaises with a "Builder Steering Committee" comprised of representatives from the City, the Saskatoon & Region Home Builders' Association and Saskatoon Land's eligible contractors; and
 - it monitors key demographic, economic and real estate market information, including information from the City of Saskatoon, Statistics Canada, Conference Board of Canada, Canada Mortgage and Housing Corporation and the Saskatoon Association of Realtors, among other sources.

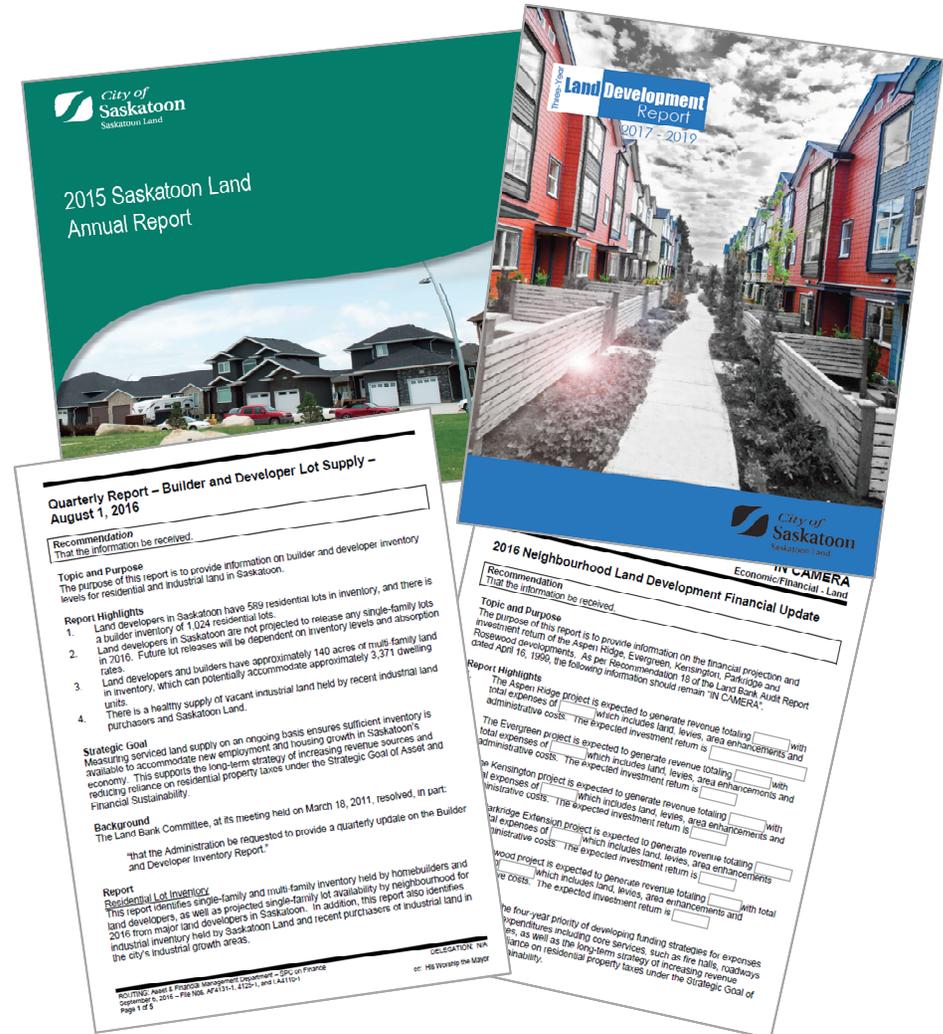
Reporting

- As a public agency, Saskatoon Land provides regular reports and updates to Administration, the Standing Policy Committee on Finance and Saskatoon City Council on various matters, including:
 - Annual Report (detailing its prior year highlights, including land sales, inventories, key accomplishments, strategic alignment with Administrative and Council priorities, and financial benefits);

Saskatoon Land prepares a number of annual reports and “in camera” documents to update Administration and the SPC on Finance on its operations.

Reporting (continued)

- Three-Year Land Development Report (an annual report that provides a summary of developer servicing plans and builder and developer inventory levels for residential and non-residential land in Saskatoon over the coming three-year period; the report also provides information on economic growth indicators, builder and developer inventory levels, servicing plans and dwelling unit demand profiles based on various population growth scenarios);
- Quarterly reports on builder and developer lot supplies and inventory levels;
- Land Development Financial Update Reports (provided “in camera”) detailing land development revenues, expenses and updated investment returns; and
- Initial business cases on neighbourhood land development projects outlining projected land development revenues, expenses and initial investment return expectations.
- These reports, together with the additional procedures undertaken by Saskatoon Land, serve to illustrate the level of due diligence and market research undertaken by Saskatoon Land on its land development projects, and how this information is communicated through Administration to the SPC on Finance (as appropriate) and to City Council (as appropriate).

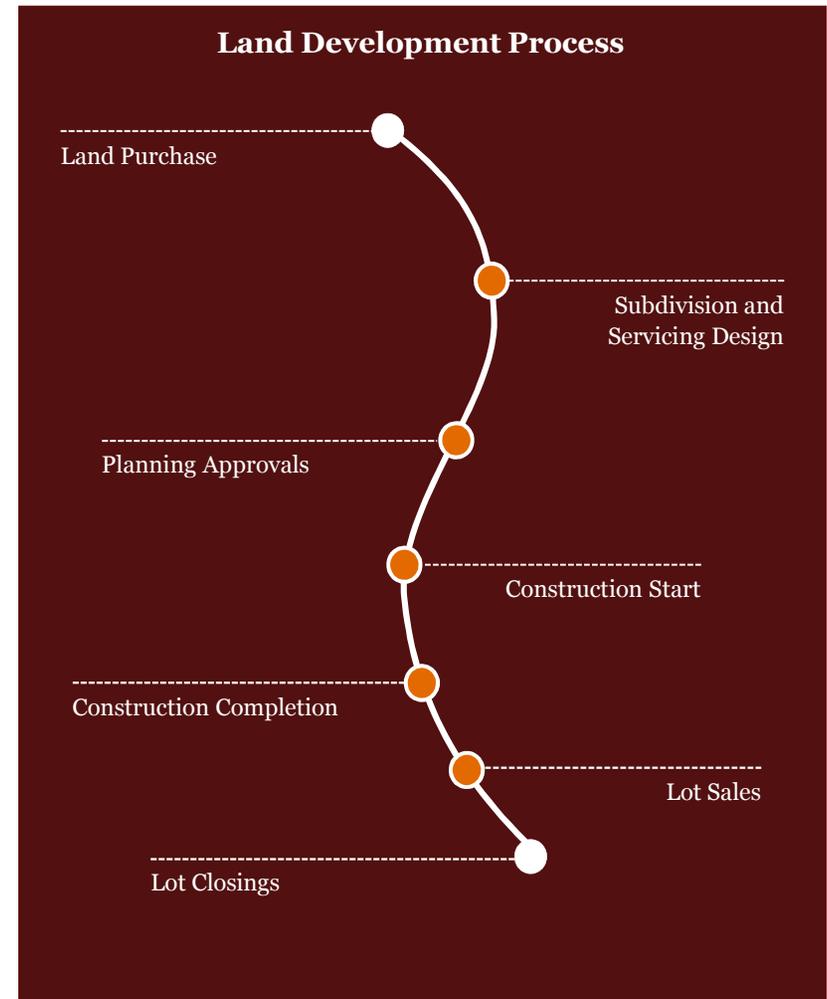


Land Development Risks

Land development is a dynamic, complex and generally long-term process, impacted by a myriad of factors including market demand, pricing, consumer choice and cost.

Land Development Process

- Real estate development is a multi-phase process involving land development, followed by the construction of residential homes or commercial/industrial buildings.
 - The land development cycle commences with a developer purchasing a tract of land. The developer then plans out a subdivision incorporating street layouts, amenities and individual building lots. As part of this plan, the developer will identify the subdivision's servicing requirements and how these are to be connected to the broader municipal systems (including water, sewer, etc.). Finally, the developer will identify how the property will be developed, including assessing if the development will be undertaken through a phased approach.
 - The developer will then seek regulatory approvals in order to allow it to commence development. Upon securing planning permissions, the developer will then commence construction, installing the "horizontal infrastructure" (roads, utilities, etc.) as well as other amenities and features required under the planning approvals (storm water management areas, recreational areas, etc.), and creating the individual building lots.
 - Upon completion of the site servicing and creation of individual building lots, the individual lots will then be sold to builders/individuals. In some instances, conditional lot presales will be negotiated prior to the commencement of construction.
- The overall timeframe between initial land purchase and when lots are closed can be years, with overall timing dependent upon a number of factors including most importantly market demand, consumer preferences and the level of competition for building lots. Because of these timeframes and influences, land developers will therefore be required to make decisions about the future many years in advance.



Land development requires a developer to navigate a number of risks in order to realize a desired return, including permitting risks, construction risks, marketing and pricing risks, consumer preferences and general economic conditions.

Development Risks

- Because the future is uncertain, there is inherent risk. As with any type of project, understanding and managing risk is crucial. For land development projects, risks occur at each step in the development process and typically include the following:
 - **Permitting risk** which includes the ability to secure rezoning, official plan/master plan approval, site plan approvals, subdivision approval, and the obtaining of various permits in a timely manner;
 - **Construction risk** which includes risks associated with cost overruns, the delayed completion of subdivision infrastructure, geotechnical issues, labour issues, financing issues, and other unforeseen problems that could prohibit the completion of the project;
 - **Marketing/pricing risk** which includes the risk of failure to sell finished lots in a timely and profitable manner, including from bringing too many finished lots to the market at one time;
 - **Consumer preference risks** which includes the risk of bringing the too many lots of the wrong size or type to the market;
 - **Economic risks** which include the risks associated with overall economic conditions that affect the housing market, including changes in mortgage rates, recessions, changing demographics, job losses, etc.; and
 - **Timing risks** which result from each of the foregoing and serve to increase direct costs, as well as carrying (i.e., financing) costs resulting from the delay in the timing of when the developer would be able to close on lot sales and realize income.
- The foregoing risks, depending on how successful a developer is in being able to mitigate or minimize their impact, will serve to decrease or eliminate a developer's expected return on investment, which per our understanding, is generally considered to be in the range of 15% to 25% (gross margin as a percentage of total expenses) or more.



Expected Return: 15% to 25% (or more)

Risk mitigation in land development is generally undertaken through a combination of upfront due diligence, continual market monitoring, development phasing and cost monitoring/management.

Risk Management

- As noted above, risk mitigation in land development is generally undertaken through a combination of upfront due diligence, continual market monitoring, development phasing and cost monitoring and management.
 - **Research/Due Diligence** is essential in assessing and managing virtually all kinds of risk. Such research will be required upfront when initial due diligence is being completed on the viability of a proposed development project. Such upfront due diligence will typically include:
 - completion of an initial business case/investment analysis, including a development yield analysis (i.e., number and type of lots), revenue potential, estimated costs of development, estimated return and overall development timeframe, to facilitate the initial investment decision;
 - geotechnical and other similar type investigations will similarly need to be undertaken to ensure the developability of the site and to identify other potential areas of concern (and to identify potential solutions and costs to overcome them);
 - local market area analysis is undertaken to identify and understand key and emerging trends influencing the economy of a local area; and
 - a residential market assessment is undertaken to identify and understand demographic and residential market parameters impacting a potential development, including pricing, demand, population growth, household formation trends, consumer preferences and to understand competing projects, etc., to identify the specific market niche(s) which would maximize the success of the project.
 - **Continual Market Monitoring** is undertaken throughout the development process to monitor and keep abreast of demand and supply trends in the market, including consumer preferences relating to lot designs (i.e., are market-acceptable lots being created), near and medium term lot supply, pricing trends, real estate market trends (including starts, completions, sales activity, changes in average price, etc.), and economic and demographic conditions (including local economic and demographic trends which could foreshadow changes in future demand).
 - **Development Phasing** is undertaken to match lot supply with expected demand and as a way to manage development expenditures (because land development requires time and upfront expenditures to acquire property, obtain regulatory approvals and construct the needed infrastructure, significant expenditures are made prior to when revenue from lot sales is generated; phasing a larger development in more “manageable” pieces allows a developer to better match expenditures, revenues, returns and hence risk).
 - **Cost Monitoring/Management** includes a developer utilizing controlled pricing mechanisms, including competitive bidding and fixed-price contracts. It also includes a developer working with external resources to verify costs, as well as keeping up-to-date information on costs from other projects for use in verifying prices.

Risk management practices are utilized by land developers to monitor the land market and enable them to match planned expenditures with projected revenue.

Risk Management (continued)

- Other mechanisms used by developers to minimize risk include:
 - **Lot Presales** where individual lots/groups of lots are pre-sold to housebuilders prior to the construction commencing. Such pre-sales are conditional and minimal deposits are provided. While potentially foregoing any increases in lot values (as homebuilders would be “locking in” prices in advance), the land developer is provided with greater cash flow certainty. Preselling lots also allows the developer to “test” the market prior to entering into construction contract commitments.
 - **Payment Timing** mechanisms are used by land developers to delay/defer when payments are made (to the extent possible) and to advance the time (and amounts) of when revenues are due.
- Utilizing the above noted risk management mechanisms allow a land developer to monitor the real estate and land markets, enabling them to better match planned expenditures with projected revenues.



Benchmarked Entities

Five municipal land development organizations were contacted to assess their current approach to risk management.

Benchmarked Entities

- As part of the scope of work completed by PwC, a number of municipal land development entities were identified and background information describing their operations and approach was reviewed. Discussions were also held to obtain additional clarity and information on their operations. Municipal land development entities surveyed as part of this review included:
 - City of Calgary, Real Estate & Development Services;
 - City of Medicine Hat, Land & Properties Department;
 - City of Red Deer, Land & Economic Development;
 - Enterprise Land Development (City of Edmonton); and
 - Lethbridge Land.
- Information sought from each entity included the following:
 - Organizationally, how are decisions made and how are they approved;
 - What reporting requirements exist;
 - How are land development costs controlled;
 - How is the local land market monitored to predict and "get ahead of the curve" on major trends;
 - How are lot draw pricing decisions made;
 - What metrics are monitored and communicated (for example, land supply, building lot availability, the level of supply that the entity is looking to have whether a six-month, one-year or two-year period, etc.);
 - Do minimum return targets on individual land development projects exist; and
 - What is being done differently in 2016 compared to 2014 before oil prices collapsed?
- In addition, information detailing returns generated by private land developers was also reviewed.

Observations

- **All entities are “for profit” municipal departments.** All entities reviewed are for profit departments of their respective municipality. In at least one instance, consideration has been given to having the entity operate as an arm’s-length Municipal Development Corporation. In some cases, the entity is the largest land developer in the community, while in others, it constitutes less than 50% and in others less than 25% of the land development market. These entities are governed by municipal policies which govern its involvement in land development.
- **While municipal entities, they are held to the same standard as private sector developers.** From a municipal approvals perspective (planning, engineering, etc.), it is noted that the municipal land development entity is held to the same standard and is required to provide the same level of due diligence and supporting documentation as would any private sector land developer. In some instances, it was specifically noted that from a transparency perspective, the municipal land development entity may be held to an even higher standard.
- **Most entities reviewed complete a risk assessment at the commencement of each development project.** Whether in the form of a business case or development proforma, most entities surveyed prepare an initial evaluation of their development projects prior to proceeding to evaluate them from an overall due diligence, feasibility and return perspective.

The approaches taken by these five municipal land development organizations were, for the most part, consistent with general industry practices.

Observations (continued)

- **All entities reviewed conduct regular market monitoring.** All entities undertake regular market monitoring of key metrics influencing the demand for and supply of residential and industrial lots in their respective communities. Metrics monitored include starts, completions, absorption, building permits, price, consumer preferences, economic statistics, demographic statistics, etc.
- **Most entities supplement their regular monitoring of development metrics with regular discussions with industry participants.** Most entities indicated that they hold regular consultation sessions with real estate development industry participants, including: individual homebuilders; the local home building association; the local Urban Development Institute, the local real estate board/individual real estate agents; industry consultants (including engineers, appraisers, etc.); and local economic development officials. In some cases, surveys are issued. Such consultations were noted as occurring as infrequently as quarterly (i.e., four times per year), while other entities indicated that they met more informally to discuss the market on a weekly or bi-weekly basis.
- **Project due diligence and market monitoring efforts have increased since 2014.** With the decline in oil and gas prices, coupled with a general downturn in the Alberta economy, the level of due diligence and market monitoring undertaken by surveyed municipal land development entities has increased. Much greater emphasis is being placed on matching supply with demand and undertaking due diligence to project land requirements against potential demand.
- **Project development costs are managed through a combination of fixed-price contracts and consulting resources.** Most entities indicated that the process used to quantify costs and ensure that tendered costs were reasonable involved the municipality's engineering department or land development agency retaining a third party consultant, knowledgeable and experienced in local land development, to assist in the preparation of plans and specifications. Fixed-price construction tenders were then led by the municipality, with the third party consultant on-hand to assist in the review of bids, particularly from a pricing perspective.
- **Return expectation vary, with total project returns of between 15% and 30% targeted.** While some entities did not identify specific return expectations, those that did indicated that, at project initiation, minimum returns of 15% were required (including financing); another entity indicated that a target return of 30% was desired (gross margin - total revenues over land development expenses, including departmental overhead costs). Actual realized returns in 2015 were 17% and greater than 40%, respectively (including both residential and industrial land development).
- **Reporting is generally through city Administration on a confidential basis.** Although a number of "in camera" reports are typically generated for internal reporting purposes, including initial business cases, project updates, financial updates and financing requests, a number of documents are also publicly made available. Included among these public documents are departmental annual reports, departmental submissions as part of the municipalities' annual budget process, project summaries and marketing documents, Council policies, governance/policy amendments, and final project reports.

Based on information detailing the operations of private sector land development entities, information monitored is consistent with those of municipal land development entities while returns are estimated to be higher.

Observations (continued)

- **Some municipal land development entities identify “land supply targets.** Not all municipal land development entities surveyed indicated that they maintain land supply targets. For those who have, supply targets of two years for residential lots was noted, while acreage targets for serviced industrial were most common. One entity’s policy requires that they not exceed more than a certain percentage of the total single family market in their region.

Private Sector returns

- As noted above, information detailing returns generated by private land developers was also reviewed. Included in this review were two integrated land development companies and one land residential land development entity.
- A review of total project returns (gross margins) over a number of different land development projects identified a return range between 21.9% (for an approximate 600-lot development) to 49.5% (for an approximate 1,600-lot development). The average leveraged return (including financing costs) is estimated to be in the range of 42%.
- In evaluating their operating environment, these entities profile:
 - local, regional and provincial economic conditions;
 - local, regional and provincial demographic trends;
 - total residential development activity in the local market (including starts, absorption, prices, housing sales, etc.); and
 - financial projections, including risk assessment.

Return Expectations	
Public Land Development Entities	15% - 30%
Private Land Development Companies	20% - 50%

Findings

Saskatoon Land’s approach to risk management is consistent with other municipal land development agencies and general industry best practices. Its returns are generally consistent with other entities, including private sector land developers.

Findings

- As noted above, Saskatoon Land is mandated to examine the demand for institutional, commercial, industrial and residential land in the Saskatoon market and based on these assessments, arrange for the appropriate quantity and type of land to be designated and developed for eventual sale.
- In adhering to various Council Policies, Saskatoon Land also undertakes additional processes designed to provide market intelligence and guidance on its business operations, including:
 - monitoring serviced residential land and lot inventories to provide it with insight and intel on future supply;
 - undertaking an annual builder survey to obtain insight on development trends;
 - liaising with a “Builder Steering Committee” comprised of representatives from the City, the Saskatoon & Region Home Builders’ Association and Saskatoon Land’s eligible contractors; and
 - monitoring key demographic, economic and real estate market information, including information from the City of Saskatoon, Statistics Canada, Conference Board of Canada, Canada Mortgage and Housing Corporation and the Saskatoon Association of Realtors, among other sources.
- In servicing land, Saskatoon strives to maintain a one-year supply of low density lots and a two-year supply of medium density lands.
- Based on information provided, we understand that Saskatoon Land is currently projecting total returns (2016), on a gross margin basis, of between 15% and almost 40% for the Aspen Ridge, Evergreen,

Kensington, Parkridge Extension and Rosewood projects. On a consolidated basis, the estimated return is in the range of 28.5% (weighted average).

- As noted in the following table, this range of return compares favourably to other municipal land development entities, as well as with some private land development companies.

Return Expectations	
Public Land Development Entities	15% - 30%
Private Land Development Companies	20% - 50%
Saskatoon Land	15% - 40%

- In generating returns comparable to other municipal and private land development entities, it is also noted that Saskatoon Land generally implements processes and procedures which are consistent with those followed by other land development agencies and general industry best practices.
 - Saskatoon Land undertakes upfront **Research and Due Diligence**, including:
 - initial business cases/investment analyses;
 - local market area analyses; and
 - residential market assessments.

While Saskatoon Land implements risk management protocols that are generally consistent with industry best practices, Saskatoon Land could implement additional protocols to further manage risk.

Findings (continued)

- Saskatoon Land also regularly conducts **Continual Market Monitoring** throughout the development process to monitor and keep abreast of demand and supply trends in the Saskatoon market, including consumer preferences relating to lot designs, near and medium term lot supply (both created by Saskatoon Land and other private land developers in the Saskatoon market), pricing trends, real estate market trends (including starts, completions, sales activity, changes in average price, etc.), and economic and demographic conditions (including local economic and demographic trends which could foreshadow changes in future demand). In conducting such market monitoring, Saskatoon Land also liaised with the local land development, home builders and other industry participants, and regularly reports to Administration, the City's Standing Policy Committee on Finance and Saskatoon City Council.
- Similar to most public and private sector land development agencies, Saskatoon Land also utilizes **Development Phasing** in order to match lot supply with expected demand and therefore in order to manage development expenditures.
- Finally, it is noted the Saskatoon Land also utilizes various **Cost Monitoring/Management** methodologies, including competitive bidding and fixed-price contracts. Saskatoon Land also works with internal and external resources to assist in verifying costs, as well as keeps up-to-date information on costs from other projects.

Additional Measures

It is also noted that Saskatoon Land could implement additional protocols to further manage risk, including utilizing **Lot Presales** in order to “lock-in” future land sales.

While providing Saskatoon Land greater revenue certainty, allowing it to “test” the market prior to entering into construction contract commitments, it is noted that total returns could be lower than currently realized (as lot sales would be committed to years before they have historically been marketed and sold). In addition, the current sales approach undertaken by Saskatoon Land (selling to both individuals and pre-approved contractors in the house-building business in Saskatoon) may need to be amended.

In this regard, it is noted that Saskatoon Land's current process involves selling a portion of residential buildings lots to builders and a portion to individuals homeowners. If pre-sales are undertaken, it would require that both home builders, many of whom are small, and individual homeowners enter into contracts years prior to the lots being ready to build home on. If presales are undertaken, it is possible that the phase being prepared could be entirely presold and no lots are left for sale to individual homeowners.

Implementing such a measure could necessitate that Saskatoon Land limit presales to a certain percentage of lots being created (to be determined, but, say, perhaps 50%) in order to provide smaller builders and individual homeowners the opportunity to purchase lots when created.

