Commercial Mortgage Insight®

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Property Developers Give Insight Into Their Construction Plans For 2006

With soaring construction costs weighing on the viability of new projects, developers and investors are focused on the basics.

Despite calls from many industry analysts for a reigning in of real estate prices and runaway property valuations, commercial real estate developers are surprisingly buoyant with respect to new projects in the planning stage, land acquisitions for future development and asset acquisition and redevelopment.

Even in the face of widespread concerns about rising energy prices, slow growth in real consumer wages and the specter of rising interest rates, the commercial real estate investment and finance machines continue to hum along, boosted by a rash of capital from Wall Street and other private investors. Certainly these are the best of times for players in the real estate development world.

The cost of construction, however, has been on the rise, with prices of some raw materials such as steel, concrete and drywall materials having risen by as much as 40% in the last 18 months alone. Under ordinary circumstances, such a sharp rise in construction costs, not to mention, the rise in labor costs in the construction industry, would have had a crippling effect on new developments.

Not so in today's capital-saturated market. While developers and the financial institutions that fund the construction and redevelopment loans of these gutsy professionals are looking at the marketplace with more careful eyes, there is little to suggest that new projects are being scrapped in the wake of fading fundamentals.

While many lenders have expressed concern about the quality of loan requests in the recent past, deals continue to get done and assets continue to be sold at record-low capitalization (cap) rates, and investors continue to face stiff competition when bidding for properties.

The pulse of the professionals who acquire, develop, redevelop, manage and trade real estate assets is a vital piece of statistics for the commercial mortgage finance sector, as the strategic stance of this group determines the volume and quality of business in the commercial real estate debt and equity finance space.


Peter Pelt

It is against this complex background that *Commercial Mortgage Insight* presents its annual National Developers' Roundup feature - with insight into the sources of new deals in 2006 and beyond. We have asked property investors, developers, owners and managers to give us their thoughts on the outlook for construction activities, their risk mitigation stance, the markets of most interest to them and how their organizations are coping with the rising cost of new construction.

We present their responses with the objective of giving potential lending and investment partners a sense of the borrowers' plans.

GROCERY AND RETAIL SHOPPING CENTERS

"For our corporate strategy in 2006, we see a move into more urban markets at the next level, since we have typically been a suburban and rural market developer."

— Peter Pelt
Senior Vice President of Construction
Equity One Inc.

We are focused on the neighborhood supermarket and retail shopping center space, which has been remarkably strong over the past three years or so. The markets we operate in (the Southeast and the Gulf states, as far as Texas and the Carolinas) have seen tremendous growth while the availability of land for new development has been scarce in certain key areas.

When I look at the south Florida market, for instance, this area has seen so much of a population growth that we have been finding it difficult to expand as we have traditionally done in that metropolitan area. The spreading of grocery and retail shopping strips has certainly contracted in the recent past, with less available and affordable land.

As a result, we are now seriously looking at the strategy of expanding through more mixed-use projects by joint venturing with residential-focused partners, while sticking to our space of quality retail developments. We are also making a significant move into more urban markets, where there is more of an investment return to be gained for the right grocery and retail configuration.

Construction cost

The rise in construction costs that we and every other development and investment firm have seen can only be offset by accepting lower investment returns, or by realizing higher rents. Since banking on a rise in rents is not realistic in many of our markets today, many players have no choice but to accept lower returns.

There is one other option, which is quite difficult for developers and investors to achieve today - that is the option of reigning in costs and improving the fundamentals of new and existing projects. I believe this is difficult to achieve today, simply because of the rising cost of both ground-up construction and redevelopment.

Kenneth P. Balin

We've seen the price of steel and other construction components increase by 30% to 40% in just the last year. Clearly, this increase in hard costs cannot continue at this pace much longer. Construction costs is a function of one's investment return so if the market rate for rents is stable or just barely rising (as has been the case with our space) and your construction costs continue to go up at these astronomical rates, then you must be prepared to see your rate of investment return go down.

We also believe that a significant factor affecting the price of labor and materials in our markets is the reconstruction process in the aftermath of the 2005 hurricanes. Those rebuilding efforts will compete for a chunk of both labor and materials, giving us reasons to trim our outlook and expectations for 2006. We think that many in this industry will have to reduce their expectations for new profitable developments in 2006, and those sentiments are also reflected in the tightening of credit standards by lending institutions.

We have determined that the way to achieve the level of growth we want is to go vertical in our projects. However, we want to remain true to our area of expertise - neighborhood grocery and retail shopping centers.

To achieve this we have been in communication with the users of our properties and they too want to move into denser markets with higher sales traffic. The idea of going "vertical" with our development outlook appeals to them, and we have already had significant interest from these users for mixed-used retail installations.

With users of our properties like Publix Supermarkets Inc., already looking into the concept of entering the denser markets with vertical stores, we are making headway into those types of deals. Joint ventures with vertical investors and developers will be a significant part of our strategy in 2006.

We are involved in a project in Hollywood, Fla., right now, to go vertical. We bought two assets - a Publix and a Walgreens - in the Young Circle corridor where there is going to be a major redevelopment project. This is a prime example of how Equity One plans to grow its business in 2006.

The Young Circle corridor is the city's way of creating a more diverse economy, beginning with how real estate is utilized for downtown workspace, living and retail shopping. We are attracted to areas where a local economy is not dependent on any one source of jobs. This is what the city of Hollywood is trying to accomplish, and we plan to be a part of that process.

The Young Circle corridor is a master plan for the redevelopment of an undesirable part of town, offering the development of mixed-use communities to replace what was considered a blighted area. We expect to see many more such projects in the densely populated areas of cities like Miami and Fort Lauderdale. We expect to see a significant amount of residential and office development as a part of these master plans.

Since we are not residential or office developers, we are planning to work with joint venture partners for the vertical development of the Publix and Walgreens properties. It is much like what we are seeking to accomplish in places like Atlanta, where there is a diversity of income sources ranging from the airline industry and military bases, to automotive manufacturing plants.

Higher density areas also allow for much higher per-square-foot rents than we have typically realized in our markets. For this reason, Equity One is actively rotating out of its rural properties and looking at markets like New York and Boston in the densely populated Northeast.

DISTRESSED REAL ESTATE DEVELOPMENT STRATEGY

"'Transformation opportunities' are typically found within markets that historically, or even currently, are out of favor for many mainstream investors and developers."

— Kenneth P. Balin, President & CEO
AMC Delancey Group Inc.

As investment dollars maintain or even increase their allocation to real estate, and supply remains in relative balance, we believe that current values will either hold steady - even with a slight uptick in cap rates - because improving markets continue to drive performance.

While AMC Delancey develops and repositions across the spectrum of asset types, we focus on long-term highest and best uses, driven by current and projected market forces that allow for an exit at a much higher value than the total project cost going in.

These types of activities include examples like converting a vacant or underutilized industrial or office building into condominiums within a hot housing market, developing a retail center on a Brownfield, developing a mixed-use project proximate to other investment activity, or simply renovating and upgrading an existing use property to benefit from improving local market fundamentals.

Internally, we categorize these assets as "transformation opportunities" and regardless of asset type, we look for the following characteristics:

■ Underutilized, distressed or vacant property.

■ Proximity to similar or complimentary private development/redevelopment activity.

■ Proximity to complimentary public investment/redevelopment of infrastructure, amenities or facilities such as airports, transit hubs, convention centers, etc.

■ Sufficient acreage or building size to realize economies of scale.

■ Highest and best use is financially feasible, legally permissible (with approvals if necessary), and physically possible.

■ Highest and best use conforms to or is part of overall redevelopment initiatives of local and regional authorities.

■ Strong local support for redevelopment activity.

Transformation opportunities are typically found within markets that historically, or even currently, are out of favor for many mainstream investors and developers. Notable examples include the South Beach area in Miami, downtown Philadelphia and even downtown Los Angeles.

We see material evidence that market forces are increasingly favoring urban infill locations, often in areas with historically negative perceptions that provide substantial opportunities. There are numerous emerging markets throughout the older northeastern and mid-Atlantic states, as well as the older developed areas of the southeast.

As economic, technological, demographic and even cultural forces continue to progress (if not, accelerate their pace of change), we see infinite opportunities that will inevitably occur from the rapid shift in land uses.

We have also been focusing on markets that support long-term appreciation potential. Such markets feature sustained population and employment growth over the next 10 years, combined with underutilized or vacant land in desirable locations within the market.

Equity One Inc. recently executed a lease with Publix Supermarkets Inc. for a to-be-built 45,600 square-foot Publix supermarket in the Winchester Plaza shopping center development in Huntsville, Ala. Winchester Plaza is a 75,700 square-foot shopping center that will be built on approximately 23 acres of a 33-acre site owned by Equity One.

For example, we are actively seeking an increased presence in Jacksonville, Fla., where we believe that opportunity exists by developing assets to serve the needs of its current and future residents, which reflect precisely those economic, technological, demographic and cultural forces.

Real estate is fundamentally a local business, and requires specific market knowledge and expertise within each asset type or development strategy. For that reason, we are actively seeking investments through joint ventures with skilled operating partners that excel in their market or asset type. In fact, we look at the operating partner first and the real estate second.

Our investment approach is particularly appealing to operating partners because we do not establish arbitrary holding periods. We like to say that the market and the real estate itself will tell us when it is time to sell, not the ill-timed needs of a financial partner.

Further, we structure our deals to align our interests with those of the operating partner, to ensure that major decisions are based on the fundamentals of the deal itself. In deciding whether to co-invest with a particular operating partner, we look for characteristics like cultural fit, investment thesis, market omniscience and reputation of a business partner.

We are also on the lookout for experience of a partner in the asset class, a good track record, operational strength and depth, and financial soundness.

Noteworthy project

Our repositioning and conversion of the Largo Radisson is a great example of a transformation opportunity. In early 2005, we acquired this property in a joint, venture with Paramount Hospitality Group LLC, a firm that specializes and excels in repositioning suburban business hotels. The property, at the time of purchase, had an abysmal reputation among area businesses and suffered from low rates and occupancy.

Through a combination of purchasing and construction efficiency, operating savvy and public relations prowess with Paramount, we repositioned the hotel and it is now enjoying excellent performance. Further, Prince George's County - just outside of Washington, D.C. - is now enjoying the development activity and appreciation in real estate values that Montgomery County, Md., has experienced for over the last decade.

Our submarket, and the hotels in it , have benefited from the redevelopment activity around the extension of the Washington Metro's Blue Line to Largo, such as the Boulevard at the Capitol Center - an upscale lifestyle retail complex - as well as planned and in-process commercial development activity taking place at the interchange of the Beltway and Route 202, where the Largo Radisson is situated.

To finance the Largo Radisson, we used short-term bank debt from Anglo Irish Bank. We maximized leverage returns by boosting loan to cost from a typical 60% benchmark to 70% via letters of credit.

We believe that debt and equity capital will continue to flow into real estate through 2006 and beyond. However, the residential sector - particularly for condo conversions - will face tightened underwriting standards as lenders and investors pull back on an obviously overheated market. For other asset types, we believe that improving market fundamentals will enable them to keep pace with rising interest rates and maintain value even with rising cap rates.

CREATING REAL ESTATE VALUE FOR INVESTMENT PARTNERS

"High liquidity in the investment markets and the availability of development capital present a good news and bad news analysis for both developers and financial partners."

— Clifford Booth, President Westmount Realty Capital Development

There is a fair amount of optimism among property development and investment players today. This optimism stems from an existing favorable pipeline of deals that span all of the major asset types.

Certainly, retail has been an unbelievable performer for investors and developers that continue to pursue it vigorously. These investors and developers are looking for more opportunities in retail, despite numerous calls from analysts and market observers for the consumer to reduce spending. The theory here is that the consumer is close to or already tapped out due to higher gas and home heating prices, and a slower pace of income growth. But the consumer continues to surprise many, and retail keeps humming right along.

There is less apartment development going on today because existing properties are being taken down in droves for condo conversions. Developers are holding off on starting new construction in this area, choosing to wait and see how many condo units will potentially come back on the market to compete as rentals. But as home prices become more unaffordable, the renters will come back to multifamily properties - possibly even as buyers of these converted condos.

Clifford Booth

Industrial is a sector that has been solid, and probably represents most of the growth potential for developers and their investor partners. As a group, it has outperformed many other sectors, and the lenders seem to prefer the industrial sector before any number of other asset types.

We see less optimism among investors and developers about office, though. And that could be because there is still an open question about the absorption of existing supply. Nevertheless, we like office even though it is not our major asset type. There is an oversupply in certain markets, but we would be buyers if it meant catching good quality assets at the right spot on the curve. Rents have not been growing by much, but we think that falling or stagnant rents represent one of the best buying opportunities here.

The capital factor

We have certainly taken note of the flow of capital from California investors into less attractive markets like some cities in Texas. The price of land and existing properties in California have risen so dramatically in the recent past, that investors who are flushed with cash are turning their sights onto places like Dallas, Houston and some of the other outlying markets in Texas.

Our core business is that we are value-added buyers so we have the tendency to be active in out-of-favor markets like some parts of Texas. Right now we think that California, Phoenix and Las Vegas are great markets to be in, but we would be cautious and very selective about new development projects in markets like Tampa, Jacksonville and Orlando, Fla., or Denver and Atlanta.

The competition for deals has been brutal, particularly when you consider how much capital investors are bringing to real estate today. When we go out to bid for properties now, we have to be quite aware of investors who come to the table with very aggressive capital.

We see this competition coming from individual investor groups like tenants-in-common (TIC) buyers, who can drive the price of deals through the roof. I continue to marvel at the aggressive prices paid by TICs for assets, and we sometimes choose not to bid against that kind of aggressive and, often, undisciplined capital.

High liquidity in the investment markets and the availability of development capital present a good news and bad news analysis for both developers and financial partners. Some may think that it is a good thing to see so much capital available for new development and asset purchase. However, when you have to bid against that much capital as we do (a value-added developer and investor), you sometimes have to just walk away from some potentially good deals.

We recently completed the conversion of the Santa Fe Terminal Urban Lofts in Dallas from rental units into condominiums and renamed it SoCo Urban Loft Condominiums. The name of the 203-unit complex was coined by Westmount to reflect the message, "South of Commerce St.," much like the New York City version: SoHo, or "South of Houston St."

The building was originally constructed in 1924. Westmount purchased it in 1991, redeveloped it into apartments in 1997, and has now converted it into a condominium project.

As a value-added play, SoCo Urban Loft Condominiums will provide an urban design of condominiums to buyers with all the amenities of urban units and access to dozens of restaurants and boutique retail outlets.

Redevelopment projects like the SoCo Urban Loft is at the core of what value-added real estate development organizations do. Our strategy is to locate subperforming or out-of-favor assets in various markets and create prized, value-added real estate.

DEVELOPING INDUSTRIAL AND OFFICE PROPERTIES FOR THE FUTURE

"The impact on us is that we must remain disciplined and not get caught up in the prevailing 'whirlwind of capital' that is sweeping the industry."

— George Garfield
President, Western Region
Transwestern Commercial Services

I consider myself fortunate, from the standpoint that the western part of the U.S. - including our major markets of Southern California, the San Francisco Bay area and the Seattle markets - are as hot as they have ever been. These are areas and market segments where all of the major growth factors are at full throttle.

Job growth is in positive territory; population growth is sustainable; and regional economic activity remains at a high level. With all of these growth factors in place, my western-focused commercial real estate market is experiencing a banner period and our greatest challenge is to match up the fundamentals of potential deals with our investment objectives, as well as the objectives of our investment partners.

Certainly, the widespread availability of capital is continuing to drive the growth of this region, but beyond that, the dynamics of the various markets and submarkets are so different from each other that deals can be structured to have different types of risk mitigation action.

I am fascinated by the San Francisco Bay area, for instance, because it has one of the most dynamic combinations of residential and commercial real estate in the country. We are realizing great opportunities as economic activity in the area continues to pick up.

Seattle is where Southern California was a few years ago, before prices began to take off. For that reason, we can still find valuations in the Seattle market that offer good returns on our investment with regard to new developments, land acquisition and value-added property buying activities.

On the other hand, the Portland and Reno markets are not too interesting for us and for our investment strategy. These are areas where fundamentals point to a significant amount of risk that we are not willing to accept at this time. In both these cases, the underlying value that we look for are just not there vis-à-vis the ensuing risk, but we are continuing to monitor these markets.

Partnerships and people

Orange County has been at the top of our list in the hot Southern California market and is by far our preferred market for investment and development activity. Among the current dynamics of the Southern California region is that there is no shortage of multifamily developments (new construction and redevelopments) but almost zero viable Class A office buildings. We see this as an opportunity to create a type of asset that will be unique to the area, and meet our investment objectives.

George Garfield

In August of last year, we announced that we would break ground on the development of a Class A office project, the first Class A high-rise development in the John Wayne Airport area in more than five years. We expect the project to be completed at the end of this year, yielding a 231,178 square-foot office tower located in the center of Irvine, on the campus of the 900,000-square-foot Irvine Center Towers.

We are excited about a fair amount of industrial land in Southern California, as well as in the Port of Los Angeles, for infill development. Job and population growth is fueling opportunities for mixed-use, multifamily and office projects. We feel that retail is not a factor at this point, since there is an abundant supply of prized retail assets in the area.

As the cost of new construction continues to climb, companies would need to have control over all other factors in their development projects. To that end, the most valuable asset that development, leasing and management companies can have at their disposal is skilled people. And to us, it is all about the people we hire and the skill sets they bring to the table.

If we have the right people in place - even in the face of adverse events like rising construction and labor costs - we will have lots of fun and at the same time, make a lot of money. Talented people allow us to deploy skills in the right place on a timely basis, and so we are looking to expand through acquiring smaller regional players. I believe that when you find a small group of people who work well together and get things done, you keep them together and let them do what they do best.

Finally, there are a lot of people who are suddenly in the real estate investment business today, and therefore we have to contend with undisciplined investors. The impact on us is that we must remain disciplined and not get caught up in the "whirlwind of capital" that is sweeping the industry. I say this because even after the abundant supply of capital disappears (and we don't know when that might occur), those who will remain in this business must be prepared to continue functioning with normal capital levels.

Our challenge is to stay focused and disciplined by choosing our projects prudently, and our investment partners equally so. There are additional issues that we, and the rest of this industry, will face in 2006. Among them is a potentially slowing economy - at that point, the people in this business for the long haul will be separated from the newcomers who simply want to make a lot of money fast. ●