

REAL ESTATE

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The Other Side of Subprime: How Developers Can Counter the Effects of the Subprime Lending Crisis

By Randhir Sahni

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Mortgage foreclosures continue to soar, and many homeowners find their financial arrangements turning sour as the nation remains focused on the fallout of the subprime lending debacle. Yet, despite all the attention, many far-reaching effects of this crisis have been underreported: the repercussions for both commercial and residential developers and what it means for the future.

RETIRING A GENERATION OF DEVELOPERS

A typical developer gets into the business to make the most money in the least amount of time, all while keeping risk and exposure at a minimum. When market demand and money supply are both up it results in lower interest rates. Lower interest rates translate to “affordability,” the trait most sought by the prospective buyer/homeowner. The demand for housing is always there—affordability is not. So, when the developer gauges that conditions are right to bring about “affordability,” the developer begins the development process.

History shows that this is a cyclical trend, and the cycle ends with the cost of long-term money rising, causing the supply to shrink, or when the Fed raises the rate, thereby tightening the money supply. When that happens, the developer backs off from the resulting exposure and risk. If, at that point, the developer

has achieved his or her financial goals for the effort, chances are that the developer will move on.

The heads of the larger development firms have many incentives as part of their contract. If these developers started with virtually nothing, and now they have a few million in cashable equity available if they leave, they certainly attempt to retire. As a general rule, developers will be in the game as long as it's clear to them that they can make money. When they see the market trending away from that, they'll retire, take the money, and move on.

In 1986, Congress passed a tax law that accelerated *many* such retirements. Now we are seeing the subprime lending situation accelerate a new wave of retirements. The common elements are cost and availability of money. When the profits decline, for whatever reason, people move on.

PLANNED DEVELOPMENTS AND MASTER PLANS—OUT THE WINDOW?

A developer, at the height of subprime lending, might have received \$200,000 for a completed house, depending on the market. Now they might only get \$160,000 because interest rates have gone up and buying power has shrunk accordingly. They cannot produce the same house because they cannot sell it for the same price. This affects how the developer

thinks while dealing with cash flow. They have to come back to the drawing board and ask: "Do we build smaller houses? Do we build on smaller lots? Do we wait and reduce inventory, thus carrying costs?"

For the developer, the subprime fallout will certainly have physical implications and things will change considerably over time. About 35 percent of every development goes into roads and open space. So if one can increase the density—which means "jam" in more houses on the same amount of land—the result is a better return. In that case, the same amount of street and the same amount of open space serves a greater number of houses, and the return goes up.

This, of course, is why the master planned communities keep their covenants very flexible; so that they can come back and change the requirements over time in response to changing market conditions.

CRISIS OF CONFIDENCE AMONG BANKS AND LENDERS

Banks are under a great deal of scrutiny now, and this has had a severe effect on their confidence in lending. They are unlikely to lend the way they used to. They will be more careful as the standards have changed, and will include more fees and points, etc., to make sure there's enough money to cover any losses or mistakes they make.

The bankers may have less confidence left in themselves—at least in the real estate end of it. They're all licking their wounds at this point in time, as they did after the S&L debacle in the 1990s, which resulted in the formation of the Resolution Trust Corporation to salvage the S&L and the real estate industry.

So banks are only going to loan money, right now, with high percentage returns. And so only those developers who have a very good product, and think they can make 25 percent or more in return, will consider such a source of money.

A NEW BREED OF DEVELOPER

What it all boils down to is that we are going to see a new breed of developers entering the arena as a result.

At the height of subprime lending, the sort of developer we saw was someone looking to turn a quick profit, and who was able to offer affordability to the would-be homeowner because money was so inexpensive. As the cost of money came down and affordability went up, they realized

that it didn't cost much more to build more house. We started to see more houses with three, four and five bedrooms, larger bedrooms, kitchens that came with all the latest technology, central air conditioning, and the houses started to bloat. As the interest rates came down, and cost per month came down, people began to buy bigger houses on the same housing budget.

That is not the case anymore, and we are seeing a mass exodus of those developers, as well as—unfortunately—people from their homes. The developers were not innovative in understanding how people lived. The new breed of developers will be those who can bring some innovation to the table; something new to make homeownership a viable option for people who couldn't afford it before.

Things are changing. The bloating may go away—except for the upper strata, which this doesn't affect—and in the coming years, a majority of the housing stock may consist of smaller, highly energy-efficient "greener" houses. And as the dollar declines in value—or has been declining—the materials coming from overseas will go up in cost, and people won't be able to afford the same house for the same amount of money.

The new breed of developer will have to work with a new set of parameters under which he or she thinks they can make a profit. It would only be speculation to say what such parameters would be, but it is likely we will see things like densities going up (in regard to how many houses on an acre) and square footage of rooms coming down, as well as a possible reduction in amenities. Shorter commutes may also become more popular.

FINDING A NEW PATH TO AFFORDABILITY

The goal is to reach out to buyers and coax them back into the market, and there are a number of tools that developers and builders might employ in bringing "affordability" back into the equation. For example, the seller could complete houses, new or pre-owned, with minimum internal finishes and equipment that can instead be replaced or upgraded over time by the buyer, thereby reducing the price. The seller could effectively guarantee to set aside an "allowance" to be used to put in appliances or other amenities over a one to two year period, instead of including all of these amenities up front and inflating the price of the house. These replacement and upgrade options would allow buyers to pay over a longer timeframe using monthly disposable income.

Builders might also consider going the route made so popular by other retailers of large-ticket items, and provide free financing to buyers for a few months or up to one year. It is a gesture that would be extremely meaningful to the would-be buyer, and a cost that would have to be absorbed by the builder, anyway, as long as the house remained unsold.

One other idea is to offer to carry insurance or pay the deductible for a limited time when the house is at warranty period. This might encourage the buyer to select the highest deductible possible, thereby reducing the premium and allowing the difference to go into buying the house.

In general, first-time buyers consider themselves unintelligent in terms of money. They hear phrases like "Buying a house is the biggest investment you'll ever make," and it scares them away. Certainly, all of the attention on people that have lost their homes as a result of the subprime lending debacle has made would-be buyers even *more* gun-shy. The builder/developer, then, has an opportunity to educate these first-timers and make them aware of the wealth of affordable financing options and tax-breaks available to them in a way that can demystify the home-buying process.

For example, builders could set up an in-house financing division that could help buyers find the best money. Either that, or refer them to a collection of trusted bankers who could explain potential pit falls and how to avoid them. It would also be wise for builders to keep an updated money availability report handy as a giveaway, to inform buyers about the index related rates such as LIBOR, or Treasury and other funding sources. Certain parties with ulterior motives might try to push these buyers toward certain options that would not really benefit the buyer; they'll feel more confident in their ability to buy a home if they know more about their options.

There is other information that the seller can provide to the buyer if the buyer insists on doing his or her own home loan shopping. If the buyers are frugal, educate them about the adjustable rate that is based on the 11th District Cost Of Funds Index (COFI). The COFI rate remains the lowest as it plays on the greed of the lender. Builders could

also act on behalf of prospective buyers and pre-negotiate a low add-on factor for buyers with institutions lending long term money. Finally, if possible, they might steer the buyer toward a loan based on a 40 year loan amortization schedule to keep the monthly payment even more affordable.

There are other tips, like these, that sellers can use to make the idea of buying a home more attractive to (potentially nervous) consumers. In short, if builders can go to greater lengths to educate their clients, help them understand the psychology of how bankers work and how interest works, they will be more likely to stay in the game—and stay loyal.

ADDITIONAL CHANGES IN COMMERCIAL REAL ESTATE

In addition to the significant changes we have seen—or will see—in residential real estate, the commercial side has seen notable shifts as well: both in terms of turnover in the field of developers, as well as in terms of properties and land that has—and will continue to—change hands. The individual examples of the latter are really too many to catalogue, but every major market has its share of development companies that have either been selling properties at a breakneck pace, or have simply dropped off the map.

The thing that will be truly interesting to note is the flush of overseas investment money that enters the market, which has happened before when the dollar was weak. In the 80s it was Japanese developers that invaded the US when the yen was strong and bought a great amount of real estate in Hawaii and the 48 states. In the 1970s, and again in the 1990s, it was the oil barons that came and bought property all over the country. And now it's going to be the Chinese, Canadians, and Indians. So whoever has the money will come to take advantage of the situation.

It is like going to Vegas and playing the dice, and then when the investors lose, out they go.

According to Hindu philosophy wealth is called *Lakshmi*, and *Lakshmi* has the ability to make its possessor move in circles. So one has to be very careful as one begins to control more resources; if not, wealth has the ability to manage its owner. The term has nothing to do with development, but it applies rather well.