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Where Are We One Year Later?

By Jason Perrin

It has been a little over a year since the collapse of such steadfast financial firms as Lehman Brothers, Bear Stearns, Merrill Lynch, and many others. Where has all the real-estate development capital gone and when will it return?

To be honest, capital targeted for our sector of the real estate space started drying up prior to Wall Street's collapse. However that wiped out any remaining capacity in the system and today we find ourselves spending more time than ever trying to establish new relationships with financial institutions. So what is the likelihood of attracting debt and equity capital to new deals today?

Many would say the debt part is relatively easy to answer - there is no debt market. I have a slightly different view. Traditional lending sources such as commercial banks are completely out of the market as they struggle to survive. What is not clear is whether or not a new breed of lender is starting to trickle into the market. Over the last few months, I have spoken with various groups that say they have pools of capital and are interested in placing debt in the form of first-trust deeds and mezzanine debt. These are typically small, private groups that target smaller deals (\$5 million to \$25 million) and their focus tends to be on commercial developments. Their pricing tends to be a current pay of near 10 percent with some form of participation taking the total expected yield up to the mid-teens. This is not cheap debt but it does seem to be gaining momentum. I would expect this part of the market to grow, particularly for the residential sector as stabilization continues and

traditional lending sources remain sidelined.

The equity side is a little more promising. There is a clear rebound in the stock market. Much of the equity capital for our business comes from Wall Street, private equity, hedge funds and other firms that place capital throughout the entire investment spectrum. When one part of that spectrum is significantly damaged—as was the case—all the other components seize up and there is a rush to retain cash. Now that capital markets are in better shape, the stock market has rebounded and confidence has returned to the system, we find equity capital slowly moving back into the residential-development space. On the commercial side, "vulture" capital is targeting highly distressed built-out properties and is staying away from ground-up development because it is cheaper to buy than build.

Another reason for optimism is that equity capital tends to move in a bit of a "herd mentality." No one wants to be the first to make a mistake by re-entering the market and deploying capital too soon. While we are a long way from a stampede, there has been enough movement that the fear of jumping the gun is behind us.

While equity capital is becoming more available, it does have some conditions that may keep it out of reach for



some developers. Groups that provide equity have taken significant hits in the last few years and those that are still around have learned some hard lessons. First, the equity flowing back into development is seeking deals in "A" and "B" markets with well-established development partners who are willing to put up a significant co-investment of 10-to-15 percent plus. The co-investment can be challenging, because in most instances deals are being financed with 100-percent equity, so 10-to-15 percent can represent big dollars. Additionally, new equity is generally seeking returns in excess of 20-to-25 percent and at least a 2.0 multiple. As competition heats up in certain segments of the market, underwriting deals to satisfy these capital requirements means getting more aggressive with inflation and other assumptions. With that said, I do see equity becoming more available in the coming quarters.

I think it is safe to say we have weathered the financial storm and capital markets are correcting. Equity is slowly starting to flow back into real estate, though we have farther to go on the debt side as commercial banks digest their remaining problems. Assuming the stock market remains strong, look for real estate debt and equity markets to normalize when job growth returns.

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