

## The Life of a Developer

*Helpful hints for budding*

*developers from a seasoned pro.*

**LIKE VIRTUALLY ALL** businesses, real estate development is about producing when demand exceeds supply. My observation, after forty years in the development business, is that very few development companies spend much time and energy analyzing historical supply and demand trends. Only during a recession, as supply exceeds demand due to overbuilding or a contraction in demand, do they begin to question the development business model.

The recession of 1991 to 1993 for apartment developers resulted from overbuilding in the late 1980s, accentuated by a recession and the attendant fall-off in demand. In the early 1990s Trammell

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Crow Residential (TCR) was unable to finance new apartment development in most of our markets. Carrying a substantial development, construction and administrative overhead, we realized that a loss of development and construction fee income would quickly result in negative cash flow, rendering us unable to cover overhead.

Unable to find any comprehensive research on the historical patterns of supply and demand for rental apartments, we contracted with Ron Witten at MPF Research to help fill the gap. In that first year, TCR worked with Witten as part of a strategic planning effort to determine whether the rental apartment development business would sustain TCR for the long term. Ron and his team worked with us to study the factors affecting market rate rental apartment supply and demand. As a result, beginning in 1991, and for the next two decades, we produced the rental apartment/multi-family outlook that analyzed current circumstances and forecast future trends for occupancy and rent growth.

During the early 1990s, developers of all product types were constrained by a lack of financing and product oversupply. At the Urban Land Institute semiannual meetings, a mood of gloom and doom prevailed. Many developers wondered if there was a future for the development industry. I will never forget Tony Downs from the Brookings Institute presenting an

outlook for future real estate development in the United States to the ULI trustees. Tony pointed out that demographic and economic factors in the United States would require significant additions to the built environment over time. The dilemma is that supply and demand is not a smooth function, and periodic overbuilding results in an inevitable pause in the development process.

Demand for new development, and most obviously for housing, is strongly influenced by household growth as well as the make-up of households. As Generation Yers reach employment age, they are more likely to rent rather than buy. Increasingly, young adults want locations close to entertainment and work (and transit where available), as well as mixed-use environments with low-maintenance living. Historically, demand for homeownership has strengthened as households reach their thirties, and is influenced by financing costs and availability, tax advantages of ownership, family/job stability and the expectation of price appreciation. However, the downturn in housing prices in the past several years (along with tougher mortgage underwriting) will defer home ownership for many households.

In part because developers need the fees associated with development, supply frequently follows the cost and availability of financing rather than a logical analysis of demand. During my career, I have

observed several periods where the availability and cost of both equity and debt financing were highly irrational. In the early 1970s, mortgage REITS (sometimes sponsored by major financial institutions) would lend 100 percent of the cost of development. My experience in community development in South Carolina at Sea Pines Company, where we borrowed for both resort community development and primary home communities, was that loans were typically at 5 percent floating over the prime rate and had five-year terms, even though the communities were expected to take ten to twenty years to develop. The first several years of loan interest was funded by the loans, and then sales projections would provide for continued interest rate payments as well as loan amortizations during the initial five-year term. At Sea Pines, the recession of 1974 and the increase in the prime rate to 12.5 percent caused a very quick default and the proverbial handing over of the keys to the mortgage lender.

In the late 1980s, commercial banks were lending 95 percent of total costs to apartment developers who would contribute their 5 percent of equity in the form of deferred development and construction fees. Once again these banks frequently became owners of the properties—this time as a result of the early 1990s recession. When I asked one bank executive why they would effectively take the equity risk on a

project for an upside of being repaid plus a spread above their cost of financing, he responded that the head of real estate had been given his departmental profit objective for the next year, which could only be met through sustained lending. That executive, he suggested, could either resign on the spot, or hope that during the balance of his real estate lending career we would not have another economic downturn. He lost his job a year later.

Supply should logically increase when demand (or projected demand) drives down vacancy. Unfortunately, our system of real estate finance typically does not anticipate markets coming into balance, is late getting back into lending, and seems always to be late in anticipating overbuilding.

#### FUNDAMENTALS FAVOR DEVELOPMENT

U.S. population growth of approximately three million people per year (one million from net immigration), along with normalized household growth of 1.3 million, provides the demand to add to the built environment. Jobs and the incomes associated with working are used to pay the rent or mortgage and to consume. Even without the demand stimulated by population and household growth, functional obsolescence along with a loss of properties

through fire, earthquakes, and so on inevitably requires some new development. In addition, as the population migrates south and west, demand for new production is further stimulated in those regions.

The median income per household in the United States is slightly more than \$50,000 and provides the cash necessary to purchase residences or rent apartments and homes, as well as to buy the goods that enable retailers and other businesses to expand. Increased employment adds to the need for new office space, and increased purchasing not only adds to retail expansion but creates the need for new warehouses.

The baby-boom generation (born between 1945 and 1964) creates a demand for specific products (including houses) consistent with where they are on the age spectrum. Senior housing for boomers, who are between forty-six and sixty-six today, is seen as a strong opportunity, as this generation begins to retire and consume financial products, vacation homes and other goods suitable to middle age and early retirement. Generation Y, on the other hand, is just beginning to form households, and should create strong demand for rental apartments and condominiums as well as student housing. Generation Y should begin to influence homebuilders with starter home demands as it moves into the workforce, marries, and begins families. On top of this,

roughly one million immigrants per year create demand for housing, particularly in locations in the Southwest and West.

#### **WHAT KIND OF DEVELOPMENT?**

Given the known demand, as well as the unique factors that can affect supply, how should a developer proceed? A developer may choose to pre-lease or pre-sell his product (contracted development), or he may build speculatively, assuming that “if you build it, they will come.” Speculative development is obviously much riskier, and should result in higher profitability, assuming the new development is carried out on a risk-adjusted basis. Home builders such as NVR, on the other hand, take a relatively low-risk posture, preferring to option single-family lots and build new homes after a contract to purchase is signed and mortgage approval is obtained. Other homebuilders inventory lots, and build speculative homes assuming future demand will absorb their product, and that buyers will be anxious to purchase and move in quickly rather than wait for their homes to be built. The recession of 2008 and 2009 demonstrated the high risk associated with inventorying lots and building homes speculatively, as one can see in many markets where large tracts of land with only roads and storm drains sit

empty, waiting for the houses that were never built.

The length of the development cycle also influences the risks associated with new development. Long development cycles, common for dense, urban and mixed-use products, make speculative development risks even greater. A development cycle of three to five years can result in delivering the product into a much different economy than existed when development began. Northeastern and West Coast markets, where land entitlement takes years and is often uncertain, make new development risks and land acquisition risks even greater. Certain types of development, such as rental apartments, are speculative developments by nature, as apartment renters will not lease a new residence unless it is immediately available. Mini-warehouses are another example of speculative development, as are small retail sites in new shopping malls. Market studies should in theory reduce the risk of speculative development, but only if the economy behaves as forecast.

A number of companies go out of business during each recession as a result of speculative development. The Trammell Crow Company was badly hurt in the late 1980s as a number of speculative office buildings were delivered virtually empty into the early 1990s recession. As the most recent recession demonstrates, developers have short memories.

## GEOGRAPHY OR PRODUCT?

Some developers, Tom Bozzuto for example, have chosen to limit their geographical reach, focusing on being the best in one or a small number of metropolitan areas. Other developers, such as TCR, focus on one product line (rental apartments) and build regionally or nationally. While financing is national and international in nature, development, with conditions such as zoning and building regulations, tends to be local. It is easier to understand market characteristics and nuances if you live in the market. You can become an expert in such local issues as development patterns, soil conditions, climate influences, local service providers, entitlement issues, risks, and timeframes. As a local developer you may more comfortably build several product lines with confidence, although most developers limit their offerings to residential, retail, or commercial.

Some developers choose mixed-use projects, although these are hard to finance and typically require a solid balance sheet and lots of equity. Mixed-use development used to be thought of as a way to diversify risks, but if one of the product types fails, risk increases. In Atlanta, for example, TCR was a co-developer of a new St. Regis Hotel and Residences building. As the economy has improved, the 150-room hotel is doing relatively well, but we sold less than half of the fifty-one luxury

residences, making it difficult to service construction debt.

Companies that restrict their development to a single product line, such as rental apartments, are able to develop a core competency in financing, design, construction, and leasing. While there are always subtle differences across markets, as the national CEO of TCR I felt more comfortable being able to evaluate new development risks for rental apartments, since I had done this type of development over hundreds of projects. In order to avoid mistakes related to the local nature of development, TCR embraced local partners who lived in the local community. In essence, we tried to have the best of both worlds by having both geographic diversity and local partners who could bring important local knowledge to the process.

An additional advantage for developers with a product focus is the ability to credibly participate in each part of the business cycle by raising funds for rehab (value added) as well as acquisitions during parts of the business cycle in which development is not feasible. As I will discuss later, having diversified revenue streams is important to a developer's stability and longevity.

## **THE DEVELOPMENT PROCESS**

Development should address an unfilled need that is identified by the devel-

oper and his team. Market research is important and should be objective, not contrived research similar to MAI (made as instructed) appraisals. Research should enable developers to ascertain product gaps and to determine important product features, amenities, and locational considerations. If family housing is involved, public school quality is important. For most product types, proximity to transit, access to retail, and access to major transportation corridors will be relevant. For some products, access to other businesses will be important as well.

Once an opportunity for new development is determined to exist, a developer should write a "word program" describing to the architect, engineers, and land planners the characteristics expected of the new development. The program should include site characteristics as well as building features including architectural style, floor plans, amenities, and so on. Whenever possible, the contractor should be part of the design team at the outset. A typical error made by developers is designing something they cannot afford to build; contractor input to the design team as you move from conceptual drawings to working drawings should keep everyone informed as to the projected cost of the end product.

Design professionals should be selected based on experience with the product type, and developers must ensure that the

planning, architectural, and design team has the capacity to execute. Developers should determine which partners on the design team will work on their project, and ensure they have the requisite background to execute on time and on budget. Before commencing construction, developers should ensure they have a firm construction budget, which is only possible if completed working drawings are made available in advance for pricing.

Construction can be self-performed or via a third party contractor. Construction executed by an in-house contractor should use, if possible, a fixed-price contract. Fixed-price contracts are desirable because they give the owner of the construction company 100 percent of the cost savings. On the other hand, if a third party is selected you will most likely want a cost-plus-guaranteed-maximum-price contract with a specified fee. The developer should keep 75 percent of the savings and 100 percent of the contingency that goes unused. Irrespective of how the contract is structured, ensure the contractor is motivated to build on time and on budget.

Regardless of ownership intentions, you will need strong asset and property managers. The asset manager will hire a property management firm (or if in-house will supervise), ensure you have experienced and competent personnel

(the on-site manager is key), and oversee leasing or selling. The asset manager must continuously evaluate the property management firm's performance. If the asset is held long-term (or is an acquired older asset), repair or rehab needs must be evaluated on a continuing basis, in addition to the opportunity to refinance. Repositioning the asset for a different market niche may also be appropriate.

Excellent property management, which optimizes NOI, drives value. In apartments, which often sell at 5 percent cap rates, an additional \$100,000 in NOI translates into \$2 million of additional value. But be careful in structuring incentives for property managers. Property managers will push for a conservative budget that they are sure to meet or exceed (and blame the economy if they don't). Push for realistic budgets and evaluate them accordingly, being sensitive to changes in the economy during the budget year. An excellent asset manager can add millions to your portfolio. Asset managers set the annual operating and capital plan, and should review the strategic plan for the asset at least annually. Refinancing an asset at the right time can significantly change the value of an asset by itself, and strategic investments in certain capital improvements can alter the course of NOI for a property as well if done thoughtfully.

## MERCHANT BUILDING VS INVESTMENT BUILDING

Many private developers in residential housing are merchant builders; that is, builders who intend to sell the product at completion or as soon thereafter as possible. During exceptionally hot markets, income properties can be sold during construction with the investor taking the leasing risk. Income properties are generally sold on a yield basis. The capitalization rate is often thought of as the cash yield a buyer would expect to receive during the first year after acquisition, typically net of replacement reserves. While merchant builders are likely to sell as soon as they feel they are getting a fair price, investment builders will hold the asset as a portfolio investment. REITs that engage in development are best thought of as investment builders.

In a downturn such as the one we are now experiencing, some merchant builders find themselves turning into investment builders, choosing not to sell into a down market with hopes of managing their assets until the situation improves. This simply underscores the importance of timing. Although you frequently hear “location, location, location,” timing means everything in your success as a real estate investor—particularly if you are an IRR-driven, short-to-medium-term investor. Many well-conceived developments

in excellent locations have resulted in huge losses because the project execution had poor timing. An example is a project purchased at the end of a price appreciation cycle, when cap rates are at the bottom and rent growth is about to reverse. For a developer, the worst timing is when you buy your land and price construction at the top of the cycle, delivering the product into a recession where demand has vanished.

Condominiums are particularly vulnerable to bad timing. With mortgage financing available at 97 percent of purchase prices it is virtually impossible to get a meaningful down payment on a “to be built” condo project. Some states such as California do not allow the seller to keep down payments in excess of 3 percent. That means that you are essentially building a spec project, hoping that the economy and sales momentum are strong when you deliver.

Luxury condo developers, including high-end resort developers, often get wealthy buyers to put up 20 percent to 25 percent of the purchase price to reserve a unit. Nevertheless, a serious market correction (such as occurred in 2008-2010) can result in buyers walking away, even from such large deposits, particularly when contract purchasers believe prices during the construction period have fallen more than their deposit. Unfortunately, lawsuits often are filed

to get the deposit back whether justified or not. Speculators, who never intend to occupy the unit, are the most dangerous buyers if things don't go as well as expected. A technique to minimize condo developer closing risks, often used overseas, as well as occasionally in unusually strong U.S. markets, is to use the buyer's money to fund construction. Some developers induce buyers to fund construction by giving them discounts at least equal to construction interest savings. Regardless of product type, investment timing is critically important. If you plan to hold the asset longer-term, timing on acquisition will be mitigated, but IRRs will nevertheless suffer if you build or acquire at the wrong time.

#### **SURVIVING THE CYCLES**

You understand the supply and demand factors and have chosen your strategy. You try to be successful through good times and bad, even if your timing is not perfect, and you know that the U.S. economy has cycles, with strong economic growth usually followed by recessions. Unfortunately, the length and severity of economic downturns varies, making it impossible to predict accurately. For example, who could foresee that the recession of the past several years would be the most severe since the Great Depression of the 1930s?

Compounding the economic losses that come with recessions is our inability to predict their arrival. Each of the past three downturns seem to have resulted from a different trigger, this past one importantly involving a "housing bubble." Rarely do you see recessions coming in time to make the necessary adjustments to your portfolio. Historically, when inflation reared its ugly head as a result of excess demand, the Federal Reserve raised interest rates to reduce inflation, often causing the economy to stall and resulting in a recession with its attendant loss of jobs. As the Fed seemingly has gotten better at anticipating inflation, other factors have triggered recent downturns.

So what does all of this economic uncertainty mean for a developer? Some real estate businesses are more vulnerable to the cyclical swings of our economy than others. The most vulnerable is speculative merchant building, while the least vulnerable is property management. Asset management is also a relatively secure business, and may even grow during downturns. The best hedge against our cyclical economy is a business with diverse revenue streams, some of which may grow in a downturn when development and construction fees (as well as profits from selling assets) decline. Firms such as Hines Interests have diverse businesses that include development, property acquisitions, and asset management. While diversified firms may

have to lay off employees in a downturn, they are likely to remain solvent, as certain businesses (such as opportunity funds) may grow in a downturn.

Developers can also hedge against downturns by the product lines they choose, as well as how they finance their businesses. Short-cycle developments such as apartment conversions to condominiums, warehouse development, strip retail and single family homebuilding can perform relatively well during a downturn since construction inception to completion is less than a year. Building properties with pre-leasing, or building only pre-sold homes can add another layer of protection.

The way development is financed can determine whether you survive a downturn. As everyone knows (but forgets), leverage cuts both ways, and excessive leverage has doomed thousands of companies. Based on my thirty years in multifamily residential development, I believe that 25 percent equity is the minimum you should inject in the capital stack on new construction of rental housing. When downturns occur, effective rents decline, but so do floating construction loan rates as LIBOR and the prime rate will normally also decline as the economy weakens.

The financing issue that is far more dangerous than rising rates is short loan maturities. Banks do most of the construction loans for apartments, and they

frequently insist on three-year maturities even if a project takes that long to build and lease-up. Being asked to remargin a loan that is delivered in a weak market is a real risk to a developer's liquidity.

Borrowing using nonrecourse debt is frequently an objective. Unfortunately, you may have to inject 50 percent of equity in a new development to get a nonrecourse (completion guarantee only) construction loan, which limits not only your IRR for the project, but also the amount of business you can do with a finite amount of liquidity.

Since condominium buyers can disappear overnight, TCR will guarantee completion of condo projects, but not repayment (amazingly such nonrecourse loans were available this cycle with only 20 percent equity). We got hurt, however, when we guaranteed marketing costs, interest and other carrying costs to loan maturity rather than simply to physical completion of the building. The lesson is that you must always do a serious downside analysis of what obligations you will be responsible for if the market vanishes before you get your condominiums to market.

Surviving the cycles is enhanced when you have an alignment of interest with the key actors in your business. At TCR we embraced a partnership structure where local partners who sponsored deals would profit or lose along with the regional and national partners based on the success of

each deal. A netting agreement ensured that losses would be offset against profits. Having an aligned interest with equity investors (and lenders where possible) gives everyone some peace of mind about motivation. One of TCR's mistakes leading up to the Great Recession was taking title to land before we were prepared to begin construction. I counted (naively) on the investment of an equity investor in the land to ensure we would start construction as soon as zoning was complete and a construction loan in-place. Unfortunately, as market conditions deteriorated, the investors walked away from their land investments leaving TCR responsible for repaying the land debt. In some instances the land value fell below the debt, and the banks immediately demanded repayment, or at least a paydown and remargin. When the downturn arrives, equity investors' and bankers' actions are determined by the circumstances at their organization, and the alignment you envisioned in a successful project may quickly disappear in a "workout," as they struggle to minimize the damage to their own organizations.

I had the good fortune early in my career to serve as CFO of the Henry C. Beck Company in Dallas, a commercial building contractor. In the mid-1990s, with our construction backlog running out, and anxious about the outlook for our company, we began a strategic planning process. Going through a process

of looking at our company's history as well as inventorying our current assets was enlightening. We learned we lost money on 20 percent of our jobs, we had limited hard bid capability, and we were heavily dependent on office construction. Additionally, we learned the two principals in the firm were almost solely responsible for business development. We also learned we were heavily dependent on Texas as a source of business, with Atlanta secondarily important. While a study of the outlook for office demand suggested the next few years would offer continued opportunities, with new office development projected to be strong for several years, we resolved to diversify our sources of revenue and our business development team, and additionally to add a "hard bid" capability to enable us to pursue countercyclical governmental construction opportunities.

**THE FUTURE OF  
DEVELOPMENT**

Young men and women entering the workforce in 2011 with a desire to be developers must be wondering what kind of opportunity exists. Adding to (or reconfiguring) the built environment will vary greatly depending on product type. Nevertheless, unless the population growth projected for the United States is

radically altered, new development will be needed to serve a growing population. Even if immigration policy becomes more restrictive, we will add more than two million new people each year. We also have to replace existing structures that become obsolete or are destroyed by fires, floods, and so on. While the need for new housing is easily understood, the demand for retail, office and other commercial building may be more heavily influenced by technological advances. Internet purchasing may continue to grow and affect the nature and amount of retail construction. Similarly, if technology enables people to work more remotely without the need to occupy an office, the need for traditional new office construction will be affected.

The availability of financing will affect the pace and nature of new developments. While I suspect construction financing will reappear in abundance once vacancies drop and rental rates increase to a point where new construction is justified, it is likely that more equity will be needed than was required before the most recent recession. This is typical at the beginning of each cycle before new construction begins again, and it remains to be seen how long the memories of the lenders will be this time.

In conclusion, being a developer in a first world country where there are families and tenants who have the financial means to compensate you is attractive. However,

memories are short and we seem reluctant to learn from past mistakes. Development can be a path to riches if a risk-adjusted return is properly evaluated and the project is soundly financed, but it can easily lead to ruin in a cyclical business environment. Nevertheless, it is creative work that will continue to inspire aggressive hard-working men and women for many years to come.