

Who is Financing Development and How?:
A Survey of the 100 Largest Projects in the U.S.

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B.S. Business Administration (1989)
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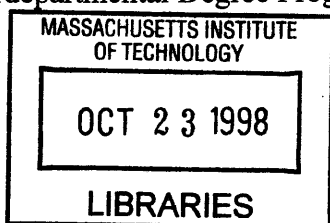
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ABSTRACT

In response to huge losses incurred from real estate investments, private capital withdrew from the market in the early 1990's, creating severe illiquidity. Wall Street, recognizing this lack of capital presented a potential arbitrage opportunity, began to issue public debt and equity securities to finance real estate.

Many believe that this introduction of the public market to real estate will impose increased discipline on the suppliers of capital; potentially reducing the probability of overbuilding. The purpose of this paper is to briefly discuss the causes of past real estate cycles and, based on a survey of current construction financing activity, to comment on the current trends in the credit markets.

The primary research for this paper, the construction financing survey, was designed to provide, from the perspective of the real estate developer, a snapshot of the loan terms currently being offered in the market. The owners of each of one hundred of the largest retail, office, multifamily, hotel and mixed-use development projects in the U.S. were contacted and questioned regarding their recent experience in securing both construction and permanent financing. The results of the study were interpreted to determine the dominant suppliers of construction and permanent financing and the level of discipline being exhibited by the credit market in general. Of particular interest was the availability and pricing of capital to fund new construction, current underwriting practices and ultimate exit strategy of the developer.

The results of the study confirm that heightened competition between a wide variety of capital market participants has resulted in favorable pricing, an elimination or significant reduction in pre-leasing, equity and guaranty requirements and an overwhelming absence of takeout financing. Furthermore, despite the recent decline in stock prices and acquisition activity, developers continue to rely on REITs to provide an exit strategy for new development. Therefore, the strength of capital market and the eternal optimism being exhibited on the part of developers and lenders seems to suggest a growing potential for future oversupply.

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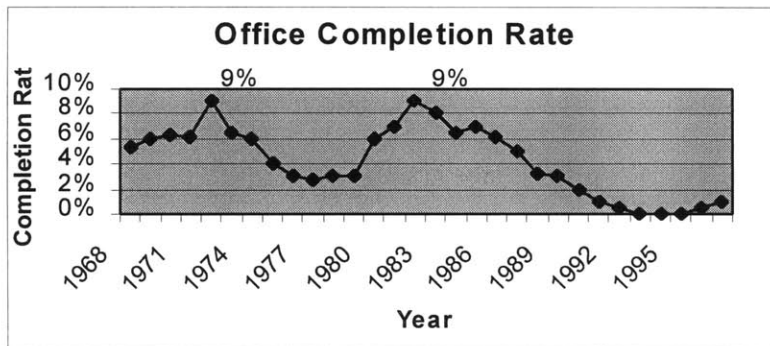
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CHAPTER 1
INTRODUCTION

Since the 1970's the United States real estate market has experienced two rather severe real estate cycles and there continues to be much debate about the causes of these recurring periods over oversupply. Although the economic conditions and government policy surrounding each cycle was distinct and different, the lack of discipline exhibited by the credit market is a well-documented factor contributing to overbuilding.

Figure 1



.As indicated in Figure 1 above, completion rates for office construction peaked at 9% in 1972 and again at 9% in 1982. While oversupply created in the 1970's, can be attributed mainly to the establishment of the mortgage REITs; deregulation and tax incentives appear to have been the major factors contributing to the building boom which occurred in the 1980's. The severe losses caused by the real estate recession of the 1990's resulted in the restriction of traditional sources of capital and the establishment of public market financing of real estate. At issue is the effect

that these new sources of capital will have on the credit markets and the probability of overbuilding.

During the past eight years the U.S. economy has experienced a strong recovery and as a result, the excess supply of real estate created during boom of the 1980's, has been absorbed much more quickly than originally anticipated. Although increased demand in some markets has caused rental rates to rise to levels that justify new construction, global financial issues and the threat of an economic slowdown loom in the background. We find ourselves at a critical point in the cycle, where a misallocation of capital could again contribute to an oversupply of real estate.

While many lenders and developers are betting that market conditions will continue to be favorable in the future, there is a growing concern on the behalf of regulators, rating agencies and industry analysts that competition for market share and profits is causing underwriting standards to decline to dangerous levels. Suppliers of capital are finding it difficult to exercise restraint and construction financing is once again being provided based on future expectations of continued demand growth. A survey of recent development projects provides an indication of how serious the potential for overbuilding has become.

Thesis Structure

The first section of this thesis presents a summary of issues surrounding real estate cycles as well as a brief description of the risks associated with construction lending. The second section describes the methodology used to conduct the survey on construction financing, the primary research for this thesis, and presents a summary of the findings. The third section, is dedicated to

three major issues identified in the construction financing survey: (1) capital supply, (2) the effects of competition on underwriting standard and (3) the exit strategy of the developer.

Conclusion

The survey confirms that construction financing is readily available in market and is not being restricted to projects with considerable amounts of equity or pre-leasing. Banks continue to provide the majority of construction lending and seem to willing to provide favorable underwriting in order to protect their customer base against the threat of other capital sources. Perhaps the most disturbing was the appearance of non-recourse lending and percentage of construction projects in development that did not have permanent financing in place.

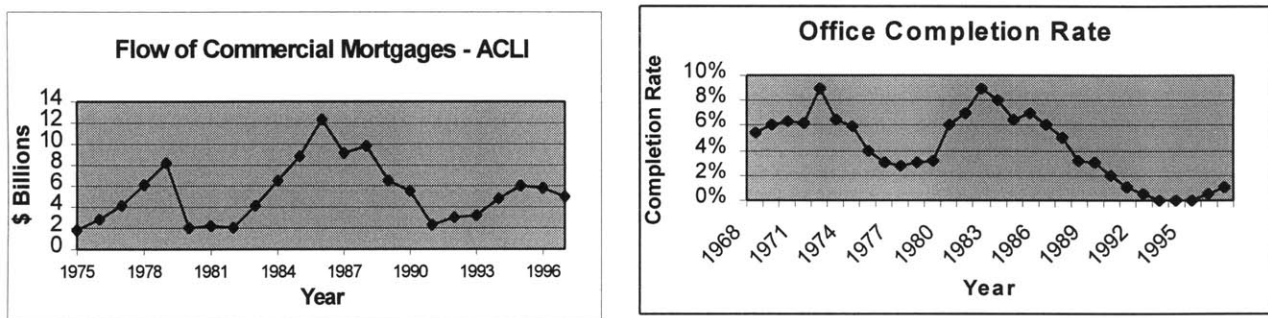
Although Wall Street lenders do not yet appear to be playing a significant role in the construction loan market, the endless appetite for CMBS product, has created a false sense of security among developers and construction lenders who enter into projects without takeout financing in place. Furthermore, a considerable amount of new development is being constructed both by opportunity funds and private developers with the expectation that the completed product will be sold to a REIT. This strategy however, seems to ignore the recent softening of the REIT stock market and the sharp decline in acquisition activity.

CHAPTER 2

LITERATURE REVIEW

The Relationship Between the Space Market and the Capital Market

Figure 2



In his 1990 AREUEA presidential address, Jeffrey Fisher explained that there are two distinct but interrelated real estate markets: the market for tenant space and the market for investment capital.¹ The data in Figure 2 above suggests that in 1985 when capital flow was at its highest point, new office construction was also on the increase and nearing historically high levels. He points out that while the use decision is made in the space market, the investment decision is made in the capital market. He explores factors affecting space and capital market equilibrium and presents a graphical framework that can be used to examine the effect of an exogenous shock from the market for space or capital.

¹Jeffery D. Fisher, Integrating Research on Markets for Space and Capital, Journal of American Real Estate and Urban Economics Association, Summer 1992, page 155

Although past research has tended to focus on a separate analysis of each of the two markets, in this study Fisher looks to identify ways in which these two markets are interrelated. He states that there are both spatial and non-spatial factors that affect the space and capital market equilibrium. Non-spatial factors are those that primarily affect the capital market and therefore affect real estate through the capital market. These factors also are not expected to affect geographic areas differently. Examples of non-spatial factors are inflation, term structure, exchange rates, tax laws. Spatial factors, on the other hand, are more closely related to the space market equilibrium and are likely to affect geographic areas differently. It should be noted however, that the affect spatial factors have on rent levels and rates of return of different geographic areas may be eliminated in a well-diversified portfolio. Therefore, they may not be priced in expected rates of return of different geographic areas. Examples of spatial factors are defense spending, oil prices and farm income.

While the supply and demand levels determine the capital market equilibrium, which establishes the risk level of an investment. The amount and type of risk for real estate comes from the space market while the premium for those risk factors that are systematic is determined in the capital market. The space market and the capital market are linked together by promised rental payments, which create cash flow streams that are sold to investors; and by the relationship between the construction cost and the value placed on that delivered space in the capital market. In the long run the value of the real estate investment should equal its replacement cost and rent levels should provide a market rate of return on that replacement cost. However, this link is not

well understood and there appears to be a “de-coupling of investment and tenant markets”,² since if we were in equilibrium appraisers would find that the income approach would always equal the cost approach.

As rental rates fall, firms are more willing to use additional space rather than other factor inputs such as labor and capital. Therefore, demand and supply both determine the equilibrium market rental rate as well as the amount of space that is leased. The price the capital market is willing to pay for the right to receive those cash flows is determined by the capitalization rate. The capitalization rate is based on capital market factors such as interest rates, perceived risk of real estate, expected inflation and tax treatment of real estate in relation to other assets.

The author used this framework to examine the effect of an exogenous shock to market equilibrium from either the market for space or market for capital. The author states that it should be evident that a change in rental rates can be induced by a change from either the space market or the capital market. An increase in demand for space will reduce vacancy, which will increase rent and increase the existing stock to restore equilibrium. Whereas a decrease in the capitalization rate should immediately increase the market value of real estate, which would stimulate construction, increase vacancy and eventually lead to lower rents. This is the scenario that occurred in the early 1980’s when the capitalization rate for real estate (relative to other assets) decreased because of favorable tax benefits provided by the Economic Recovery Tax Act of 1981.

² M. Atef Sharkawy, “The Role of Appraisal in Acquisition-Development Construction Loan Default” paper presented at the December, 1990 annual meetings of AREUEA.

Therefore, while past research tended to focus on a separate analysis of either the space market or the capital market as if each market was autonomous. A “holistic” approach that simultaneously considers space and capital markets is difficult but will provide a much better understanding of real estate performance and market cycles.

Demand Volatility and Real Estate Cycles.

Steven Grenadier developed a model that attempts to explain the underlying causes of the prolonged real estate cycles.³ Grenadier begins by presenting time series data relating 1970’s and 1980’s office vacancy rates. He concludes that since there are similarities in the cycles, in order to understand the causes of the boom and bust behavior of real estate markets in general we must look beyond specific issues of the time such as tax law changes and bank overhauls.

In particular, Grenadier looks for an explanation of the persistence of both high and low vacancy periods noting vacancy rates differed significantly across property types. Grenadier’s focus in the paper is to develop a model that explains this underlying causes of the prolonged cycles observed in the market and to distinguish the features that make particular property types more prone to boom-and bust behavior.

The model analyzes two specific aspects of market behavior. The first behavior that the model addresses is the unwillingness of building owners to adjust rents and occupancy levels to

³ Steven R. Grenadier, The Persistence of Real Estate Cycles, Journal of Real Estate Finance and Economics, Volume 10, Number 2, March 1995, page 95-119

changing economic environments. The second behavior the model addresses is the recurrence of overbuilding, where large quantities of buildings are delivered during periods of high vacancy. It is the combination of these two effects that is the foundation of the model's explanation for the persistence of real estate cycles.

The analysis begins by looking at the two standard explanations of real estate cycles from the supply side. Although he agrees that while the length of construction lags help to explain the cyclical nature of the downtown office market, it does not explain the cyclical behavior of the industrial market where construction times are typically less than a year. The second supply side explanation of real estate cycles he examines is the use of non-recourse lending, where developers continue to build as long as financing is available. This however, does not explain why overbuilding is more prevalent in some markets than in others and why overbuilding is observed in other countries, such as Canada, where non-recourse lending is uncommon.

The model that the author has developed to explain real estate cycles more completely, relies on option pricing literature, particularly the option inherent in the decision to convert raw land into developed property. The model is presented in three stages: the leasing stage, the construction phase and the development decision..

The leasing stage, focuses on the relative strength of the demand for renting the property and the "stickiness" of vacancy rates. Stickiness refers to the tendency for units to remain vacant for long periods of time (even if demand rebounds) and for occupied units to remain leased (even if demand becomes depressed). It is the uncertainty of the future demand that makes the owner

more cautious about making a capital outlay to rent the marginal unit. The owner exercises his option to wait, which is referred to stickiness of vacancy rates.

The leasing phase of the model addresses the magnitude of vacancy rate across real estate markets since the demand for real estate is a derived demand dependent upon the strength of the business climate for the space user. Therefore, different property types and properties located in different geographic areas may have greater demand volatility, which may produce greater stickiness in vacancy rates.

The second stage of the model, the construction stage, looks at construction time for real estate and the inability to reverse the development decision. The third stage of the model, the development decision, focuses on the value of the raw land, since its value is determined by the option to begin construction at the optimal time. The developer chooses to begin construction when demand is such that the value of the property (based on the present value of the future cash flow to be generated by the property) is maximized.

The author used the three stage model to predict the effect of construction times, adjustment costs and demand volatility on the probability of overbuilding. With regard to construction time, the results of the model indicated that the longer the construction time, the greater the probability of overbuilding. Furthermore, as with financial options, the impact on value is asymmetric with respect to the extremely favorable and unfavorable outcomes. If demand for units is high when excess space is delivered the developer will exercise its option to lease the units at high rents, and if it is low the owner will wait for the market to turn before incurring

adjustment costs. The benefit of the extremely good outcome outweighs the cost of the extremely poor outcome. Therefore, the developer will always err on the side of increasing the probability of overbuilding because the tradeoff is favorable.

With regard to the leasing phase, the author found that a small increase in factors such as tenant improvements and commissions will magnify the stickiness of vacancy in existing buildings. As a result, developers are more cautious in their timing and wait for higher demand before building; however they are not cautious enough to actually reduce the probability of overbuilding. The asymmetry of good and bad outcomes holds.

In summary, the three stage model suggests that certain property types, such as office and industrial, will have more of a tendency to be overbuilt and that cities with undiversified economies, and therefore more demand volatility, will be also be more prone to overbuilding.

Oversupply and the Perceived Demand for Space

Research conducted by Edwin Mills focused on the office market recession that occurred during the 1980's and the probable reasons for it.⁴ Mills used office construction and employment data compiled by Salomon Brothers to identify trends in the delivery and demand for space over the 1970's and 1980's, noting that 60% of the office space ever built in the U.S. was built during this time.

⁴ Edwin S. Mills, Crisis and Recover in Office Markets, Journal of Real Estate Finance and Economics, Volume 10, Number 1, Jan 1995

He found that at the end of 1985 office employment was falling even though the national economy was growing rapidly and was close to full employment. Hence, the real problem was created in 1989 when office space growth outstripped the decelerating growth in office employment. The explanation offered as to why demand for services, and therefore office employment, slowed while total employment continued to rise, is that strong growth had occurred in the service sector since 1982, and that the service area was beginning to reach saturation levels. Furthermore, he contends that oversupply occurred because construction continued at high levels after 1986, based on excessive optimism about future growth and a failure to perceive that demand had fallen to a much slower long term pace.

Although Wall Street's involvement in the real estate market has increased the level and quality of information available to providers of capital, it is not yet certain suppliers of capital will not fall into this trap again.

The Role Of Capital In Real Estate Cycles

The 1970's: Mortgage REITs and Disintermediation

In the late 1960's Congress enacted Section 856-858 of the Internal Revenue Code, creating the Real Estate Investment Trust.⁵ However, it was not the late until 1969 when mortgage money was in tight supply that REITs really began to gain popularity. Mortgage REITs provided developers with a much-needed alternative to traditional bank financing and appealed to investors as a diversified real estate investment with dividends that were not subject to double taxation.

⁵ Ridloff, A practical guide to construction lending, Van Nostrand Reinhold Company Inc. New York, 1985

REIT sponsors were paid substantial advisory fees based on total assets under management, which encouraged the utilization of leverage. It was also common for investors to require the investment of committed capital within 60 days of the issuance of the offering, putting pressure on the sponsor to identify loan product. The abundance of capital that was created in the market as a result of the mortgage REITs significantly increased competition and eventually lead to a weakening of underwriting standards. It was not long before construction loans were available for 100% of the project cost, regardless of whether a takeout loan was in place. In addition, as the volume of new construction increased less consideration was given to the viability of the project and less scrutiny was placed on monitoring the construction loan process.

The REIT market changed dramatically when interest rates increased by 10%. Construction loan interest reserves were quickly depleted and takeout commitments, if they existed, were cancelled. This combination of rising cost of funds, lack of takeouts, and poor underwriting had severe repercussions. Investors who experienced huge declines in dividends initiated litigation and many REITs were forced to either repurchase existing shares or to file bankruptcy. By the late 1970's the industry began to rebound; however, banks faced increased competition for deposits from new investment products, such as money market funds, which offered higher interest rates than the regulated banks were permitted to provide. This inability to compete for deposits eventually led to the deregulation of banking of the 1980's.

The 1980's – Deregulation, Taxes, Institutional and Foreign Investment

Deregulation of financial markets in the late 1970's and 1980's, eliminated interest rate ceilings and permitted institutions greater flexibility in investing depositor's money, while deposits

remained fully insured.⁶ Deregulation was designed to eliminate the disintermediation problem by creating competition between the regulated and unregulated financial institutions. It encouraged lending institutions to venture into new product markets and geographical areas in order to better diversify their lending portfolio and generate higher returns. Construction lending in particular was identified as an excellent asset and liability matching technique.

While deposit insurance levels were increased, charter requirements for banks were eased and unscrupulous characters were permitted to establish lending institutions. Managers and owners of these institutions had little equity at risk were protected from potential losses and therefore benefited from making high-risk loans. As competition from new financial sources increased, loan underwriting standards deteriorated. Eventually, these conditions, as well as fraud and failure to enforce existing regulations, lead to the savings and loan crisis of the 1990's.

Tax law changes which were enacted in 1981 introduced the concept of accelerated depreciation. The new 15 year depreciation schedule provided large tax losses for the owners of real estate, allowing them to shield a significant portion, or all of their income, from taxes. While these changes were introduced to stimulate real estate investment, they provided real estate developers and limited partnership syndicators with enough incentive to continue building even when demand was inadequate to fill the newly constructed buildings.

In addition to the loose capital being provided by banks, large amounts of long term financing also came from pension funds, insurance companies and foreign investors. Academic research

⁶ Timothy J. Riddiough, , MIT Real Estate Finance and Investment, Fall 1997 Course Notes

conducted in the late 1970's and early 1980's provided evidence that commercial real estate produced higher returns than bonds, were lower risk, and had almost zero correlation to the market portfolio. Portfolio managers at insurance companies and pension funds viewed real estate as a separate and distinct investment which would increase portfolio returns, reduce overall market risk and provide a hedge against the inflation experienced in the 1970s.

Armed with this new data, real estate professionals assumed the role of investment managers and created a lucrative new agency business. However, as was the case with the REITs of the 1970's, these managers were typically compensated for their efforts through a widely accepted fee structure, which was based on the amount of assets under management. This fee structure, combined with the institutions' eagerness to meet the newly established portfolio allocations levels for real estate, continued to create demand for assets, masking the underlying signs of overbuilding.

Foreign investors, particularly the Japanese, were enjoying economic prosperity in their own countries and also looked to the U.S. real estate market for investment opportunities. The strength of their currency and the relative price of Japanese real estate made U. S. trophy properties look like a bargain. Therefore, during the mid 1980's, when actual demand for office space was declining, foreign investment continued to drive prices higher.

1990's – The RTC and Wall Street

In an effort to regain control of the troubled banking system, the federal government introduced the Financial Institutions Reform and Recovery Act (FIREA).⁷ FIREA imposed lending restrictions, stricter capital requirement and increased regulation to the banking industry. However, by this time, the U.S. was already feeling the effects of the economic slowdown. The regional recession in Texas became a national problem and savings and loans, unable to meet the obligations of their depositors, were taken over by the federal government.

The RTC was established to manage and liquidate the large inventory of mortgages and real estate that had been acquired from failed banks. Political pressure made it implausible to wait for the stronger real estate market to sell into and selling the assets one at a time was too expensive and time consuming. Financial engineers from Wall Street recognized the arbitrage opportunity and applied the same principals that had been developed in the residential mortgage backed securities market to purchase the assets in bulk from the RTC. In essence, the RTC and the federal government absorbed the startup cost of the commercial mortgage backed securities (CMBS) industry.

Due to the losses incurred from real estate, many lending institutions were unwilling or unable to issue new debt. This created a situation where even well capitalized investors could not secure refinancing for expiring mortgages. As a result, many real estate operators turned to the public markets for re-capitalization. Wall Street provided the vehicle to enabled public market

⁷ Ridloff, A practical guide to construction lending , Van Nostrand Reinhold Company Inc. New York, 1985

investors to provide these companies with an abundance of cash, which they then used to acquire properties at well below replacement cost. As the real estate markets recovered these investors were rewarded handsomely.

The infrastructure that was created to purchase debt portfolios from the RTC was subsequently expanded to provide for the conversion of all types of whole commercial mortgages to investment securities. The market for CMBS product grew rapidly as investors felt that investing in securities as opposed to whole loans would provide lower overhead and allow them to better liquidity and the ability to invest in distinct asset classes with specified risk ratings, return expectations and investment time periods.

Discipline and Future Role of Capital Supply

Many industry professionals believe that Wall Street's involvement in the real estate markets will provide more discipline, which will reduce or eliminate the real estate cycles that have occurred in the past. A recent article by Sally Gordon discusses the current players in the real estate capital markets and their ability to impose discipline on the industry. In essence, she is seeking to identify who has the legitimacy and power to prevent what may seem to be inevitable.

Gordon indicates that there is both hard data and anecdotal evidence to support the impression shared by many lenders on the front line of a very competitive industry, that pricing spreads are very thin and underwriting standards are eroding.⁸ As proof she points out that in December

⁸ Sally Gordon, Real Estate Capital Markets: Who's the Daddy?, The Real Estate Finance Journal Summer 1998 p5-13

1997, commercial mortgage spreads were only 88 basis points over treasuries, the narrowest in this real estate cycle. This concern was confirmed by a KPMG study of commercial real estate lending strategies, which indicated that competition not risk was driving pricing. Furthermore, although tighter pricing may be justified if underwriting standards were proportionately more rigorous, however, the trend that has been identified raises questions about how prudently the market is allocating capital. Many would argue that at this point in the real estate cycle, underwriting should be getting more rigorous not less.

Critics contend that the price of capital at various phases of the real estate cycle does not reflect the risk inherent in the underlying assets. Rather, capital tends to flow into real estate simply because investors seek higher yields in alternative asset classes. Furthermore, since Wall Street issuers do not hold securities, they do not have sufficient incentives to more efficiently price real estate capital. Attention is often shifted away from local demand for the asset and focused more on the larger capital market factors and the relative value of available alternative investments. Particularly with instruments such as REITs and CMBS, which create diversified pools of real estate investments, it is difficult to penalize investments in a particular market and therefore, Wall Street has limited ability to effectively discriminate the price of capital to those specific local markets.

Securitization does not reduce risk; it only reallocates it. Therefore, the CMBS investors who should be most concerned at this point in the cycle, those bearing the most risk, are the B-piece buyers who incur the first loss. Although participants who entered the market early on are expected to benefit from initial pricing inefficiencies; as the CMBS market has matured, pricing

on B-pieces has tightened significantly. Between early 1996 and mid 1997 BBB spreads narrowed by about 90 bp. Perhaps more importantly however, is the fact that B-pieces are also becoming a much smaller portion of the overall security pool. In early 1995 an average of 8% of the issue was rated single-B, by 1997 the B piece was reduced to 2%.

Therefore, although B-piece buyers may be motivated to exercise discipline they lack the scale necessary to impose it. Furthermore, many of the B-pieces purchasers are also servicers who must purchase the securities in order to obtain the ability to service the issue. Five years ago there were ten servicers controlling 40% of the market, now 5 servicers control over 65% of the market. Due to the economies of scale that are necessary for servicers to generate a profit this consolidation is expected to continue. Furthermore, it is not uncommon for a servicer to purchase B-pieces at small or negative spreads in order to maintain future servicing contract cashflow.

Investors rely heavily on the opinions of rating agencies as to the quality of collateral and structure of the security. However, as with other segments of the capital markets, they too are allowing their judgement to be compromise as a result of increased competition. The fact that subordination levels are being reduced should signal that collateral value is improving. However, at this point in the cycle this would seem unlikely. The level of issuance that the rating agencies are responsible for has increased dramatically and is only expected to continue to grow. This put additional pressure on staff, particularly when investment banks continue to offer large compensation packages to lure seasoned employees to the other side of the table.

This article makes a strong case against the argument that the introduction of the public markets will prevent the next real estate downturn. Currently, Wall Street does not appear to be prepared to efficiently adjust prices for real estate capital that are responsive or sensitive to local markets or to real estate cycles. Instead pricing is being driven by the business cycle and the price of capital for and yields in other asset classes. Competition, not underwriting, is driving pricing in primary mortgage markets. Sellers of securities have little incentive to exercise constraint. Buyers of the riskiest securities lack sufficient scale to impose discipline; and other intermediaries, such as servicers and rating agencies, are making decisions based on the current climate without regard for the full cycle.

The Risks Associated with Construction Lending

Construction lending is generally considered to be real estate lending at its riskiest. Where in order for an institution to be successful it should maintain a staff of highly trained individuals that are capable of underwriting the transaction, administering the loan and monitoring the construction process. Although no lending is without risk; construction lending inherently has two distinct risks that should be carefully considered prior to committing to the first dollar.⁹ The first risk is the danger of non-completion and the second inherent risk is that once completed, the project is not economically viable.

The most common cause of non-completion is insufficient capital. This situation can be the result of several factors including underestimation of cost, unexpected increase in costs, slower

⁹ Joseph ,Tockarszewsky, Real Estate Weekly June 25 1997,

than anticipated lease-up, as well as cash flow problems of Borrower or a principal which may be unrelated to your project. Delays resulting from labor or material shortages or difficulty with the general or sub contractors can also cause a project to lose momentum, which may never be regained. Finally, damage or delay caused by fire, flood and other catastrophes may be insurable, however, the loss of time can not be recovered. Any delay that causes the developer to “miss the market” will cause all parties to suffer.

If the completed real estate project is not economically feasible its value will not be sufficient to repay the loan. Failure to achieve the projected level of economic success may be the result of poor location or design, improper pricing, underestimated expenses or poor analysis of supply and demand conditions. Although pre-leasing provides the developer and lender with a level of comfort, it does not ensure success.

Interest rate changes can effect an otherwise sound project, as increase in the cost of short-term money will impact the cost of the construction loan while an increase in the long-term rates will make the takeout lender more reluctant to fund its commitment. Furthermore, an increase in the long-term interest rate will increase the cap rate, which is used to determine property value and the end result could be a property that cost more (due to increased construction loan costs) and is worth less (due to an increase in the cap rate).

Relationship Lending , Equity Contribution and Guaranties

Perhaps the most successful way to reduce the aforementioned risks is for the construction lender to establish relationships with Borrowers that have demonstrated an ability to perform. The best

evidence of the Borrowers ability to perform is experience or track record. If the lender does not have a long relationship with the Borrower it is important to obtain references from other lenders, bonding companies, contractors or other industry professionals to provide insight on the Borrower's character and performance prior to committing capital. A lender that is conducting business in a new area should also become familiar with local laws, customs and conditions, such as availability of labor and materials, or align itself with a knowledgeable local agent.

The Borrower should be financially sound and be required to contribute substantial equity and a guarantee to ensure adequate capitalization and completion of the project. Assuring the completion of the project begins with an accurate estimate of what it will cost to construct the structure, build out the space, pay brokerage fees and subsidize the operations of the project until positive cash flow is achieved. The lender should also structure the loan so that the Borrowers capital is contributed first, before the construction loan is funded, and there should be a holdback of funds to ensure the payment of contractor retainage, tenant improvements and FF&E. If the Borrower's financial strength is in question the lender should not proceed or at the very least, a substantial third party guarantee or credit enhancement should be provided.

Underwriting

The developer should be required to submit a preliminary application including the details of the project, such as plans and specifications, feasibility studies and projected income and expense statements. The lender's internal staff or a recognized appraiser should then conduct an independent appraisal of the property. This analysis should include a thorough underwriting of the tenants that have committed to lease space in the project, as well as determining a breakeven

analysis. The lender will also want to ensure that the projected income presented in the appraisal will be sufficient to support the takeout loan.

Takeout Financing

Financing commitments from permanent lenders are seldom firm commitments. All long-term commitments have escape clauses that provide the takeout lender with the opportunity to avoid funding the loan. They also typically contain a floor amount that will be funded upon completion of construction, with additional funds to be funded upon reaching operating or leasing targets. With that in mind, the construction loan should be structured so that it does not exceed the floor amount. To ensure that the project, once completed, will meet the permanent lenders requirements, a buy sell or tri-party agreement should be negotiated and executed by all concerned parties.

Tri-party Agreements

The tri-party agreement is a contract executed by the developer, the construction lender and the takeout lender, which specifies that upon the satisfaction of various conditions the permanent lender will pay off or purchase the construction loan. This type of agreement is necessary since during the construction process the permanent lender has little direct involvement in the project, yet the construction lender wants to be certain that the finished product is acceptable to the permanent lender. For this reason the definition and interpretation of the term “substantial

completion” in accordance with the approved plans and specifications becomes a central issue of the tri-party agreement.¹⁰

Because many permanent lenders are not staffed to monitor the construction phase, it is helpful to have as many issues as possible approved up-front. The construction process is often unpredictable and change orders are inevitable in any size project. Therefore, in order to avoid jeopardizing the takeout, the construction lender should seek the permanent lender’s approval for any necessary changes to the project. The language used to describe the formal obligations of each lender to inform the other of changes in condition of the project or the borrower should be expected to be the subject of much negotiation.

¹⁰Luskin, Martin, Real Estate Construction Financing: The Pitfalls of the Tri-party Agreement, The Real Estate Finance Journal, Winter 1996 p.30-33

CHAPTER 3

SURVEY METHODOLOGY AND RESULTS

The primary research for this paper was based on a survey of the 100 largest new development projects in the U.S. The survey was designed to document the specific financing arrangements for each project as a vehicle to determine the availability of capital in the market and the potential effects of increased competition on underwriting standards. The question is whether construction lenders are creating a potential for overbuilding, by relying on continued strong economic growth and increased demand for space instead of focusing on the economics and viability of the project.

As opposed to other surveys that have obtained loan data from the suppliers of capital, the focus of this research was to solicit responses from developers regarding their recent experience in obtaining construction and/or permanent financing for their current project. The objective of this approach was to obtain a more realistic and current picture of the financing terms actually being offered to and used by developers in the market today, rather than focusing on the specific lending practices of a limited number of financial institutions.

A data service provider, well noted for its involvement in the construction industry, was identified to obtain background and contact information on the 100 largest projects currently under development in the United States. The database that was utilized was compiled through discussions with established local development contacts as well as through legal filings. The company provided access to its database and a program was designed to select a sample of the

largest projects from the categories of office, retail, industrial, hotel and mixed use. Careful consideration was given to obtain a sample that was geographically balanced

The database provided general information relating to the project such as location, product type, size and construction cost, as well as the owner/developer with a contact name and number. The initial approach used for data collection was to contact the firm and speak directly with the Chief Financial Officer regarding the construction financing process. This however, proved to be very time consuming and produced only a limited number of immediate responses.

Shortly thereafter it was determined that this initial approach would not allow an adequate number of responses to be collected within the project limited time frame. The data collection approach was therefore modified and re-implemented. The revised approach entailed establishing initial contact with the company to determine the appropriate party responsible for the arrangement of construction financing. All vital information relating to this individual was obtained at this time including contact name, title, phone number, facsimile number, email address and assistants name. This data was added to the database in anticipation of conducting follow-up calls.

Once contact was established with the appropriate party a brief explanation of the project was provided. A cover letter was written explaining, in greater detail, the purpose of the inquiry and a description of the research topic. A one page written survey was also prepared to accompany the introductory letter. Recognizing that the individuals that were to be contacted would have limited time to review and completed the survey, the design and layout of the survey became

critical. It needed to be brief, yet sufficiently cover the most pertinent terms of the construction and permanent mortgages.

In an effort to increase visibility and speed response time turnaround, the documents were distributed by facsimile on MIT letterhead. The transmission included general guidelines for completing the survey questions as well as a date to provide responses by. Although some individuals responded immediately, expressing a strong interest, a great deal of time was spent following up the initial contact in an effort to increase the number of response. Several individuals that were unwilling to submit written responses, provided their comments via telephone conversations.

The Results

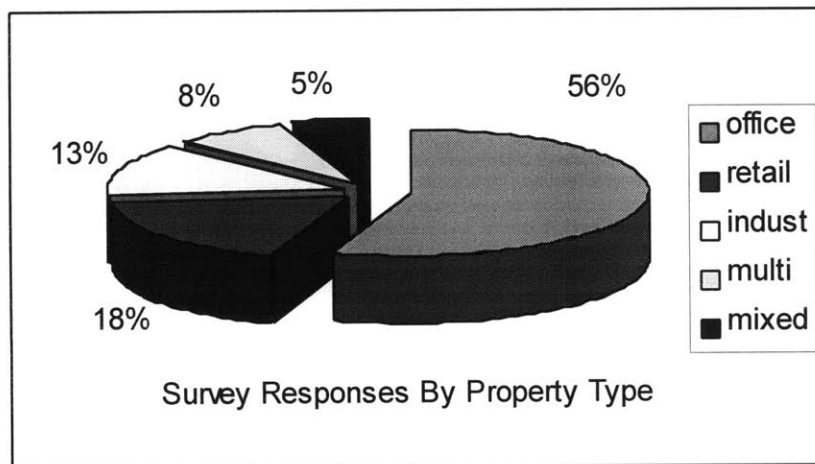
At the end of the survey period a total of 41 responses had been received. The responses were well balanced geographically and by product type representing a wide variety of ownership structures.

Responses by Property Type

<i>Type</i>	<i>Number of Solicitations</i>	<i>Number of Responses</i>	<i>% Of Total</i>	<i>Location</i>	<i>Average Project Size (\$ millions)</i>
Office	27	21	54%	NJ, IL, MA, NY, OH	69
Retail	14	7	18%	NH, RI, OH, NY, FL	123
Industrial	20	5	13%	CA, TN, FL	12
Multifamily	22	3	8%	VA, TX	77
Mixed Use	17	2	5%	MA, TX, IL	160

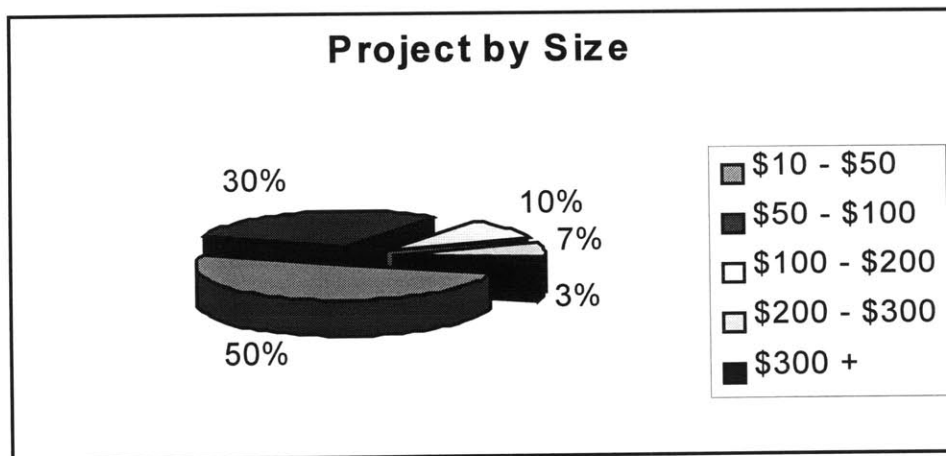
The survey responses include 54% office, 18% retail, 13% industrial, 8% multifamily and 2% mixed use projects.

Figure 3



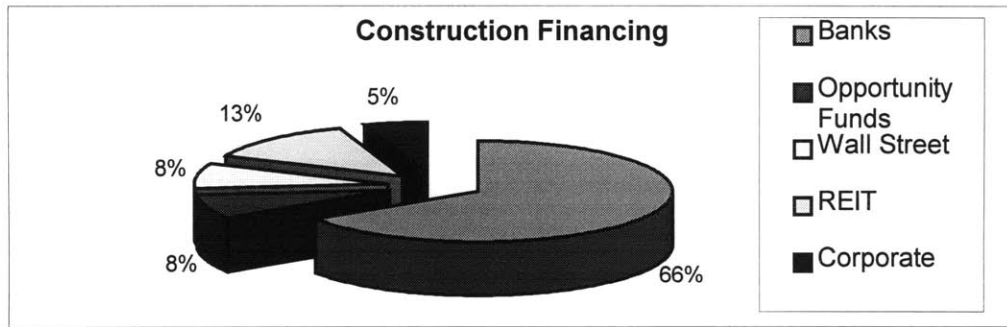
The project size varied tremendously and was closely related to property type. The largest project included in the survey was a \$340 million office tower located in New York and the \$10million industrial building located in Florida. Approximately half of the projects ranged between \$10 million and \$50 million

Figure 4



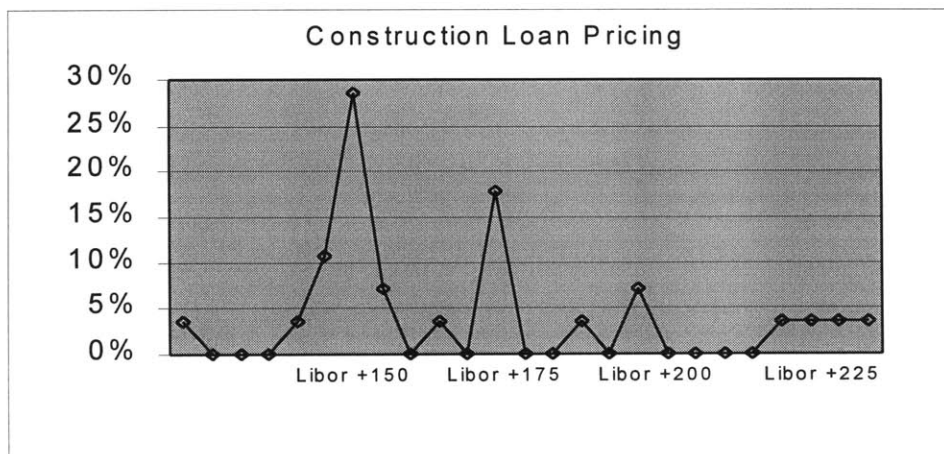
Not surprisingly, 66% of the construction financing was provided by traditional banking institutions, 8% was provided by Wall Street lenders, another 8% was provided by opportunity funds, 13% was financed internally by REITs and the remaining 5% internally by corporations.

Figure 5



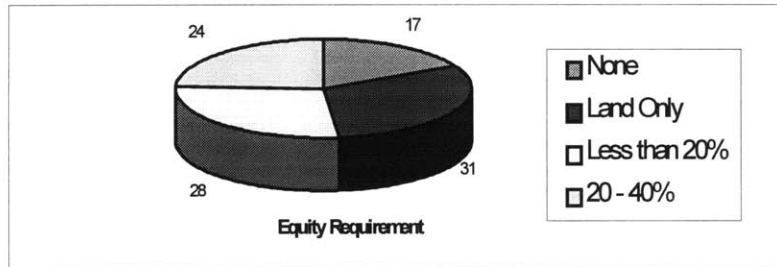
Pricing of the construction loans were predominantly based on a spread of 120-150 basis points over libor. Pricing ranged from a low of Libor +120 for a build to suit industrial project to Libor +275 for a speculative CBD office tower.

Figure 6



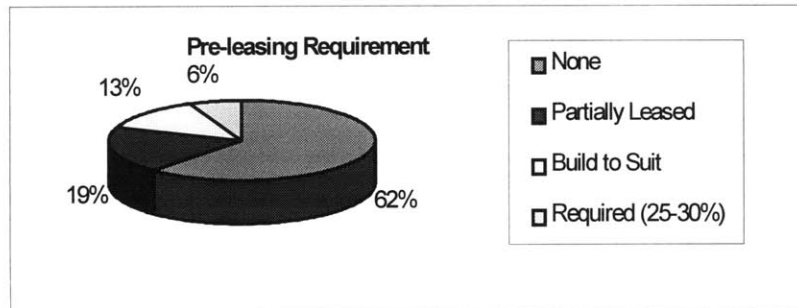
Although 24% of the projects required 20% or more equity, 17% of the projects required no equity contribution from the developer and another 31% required only land contribution.

Figure 7



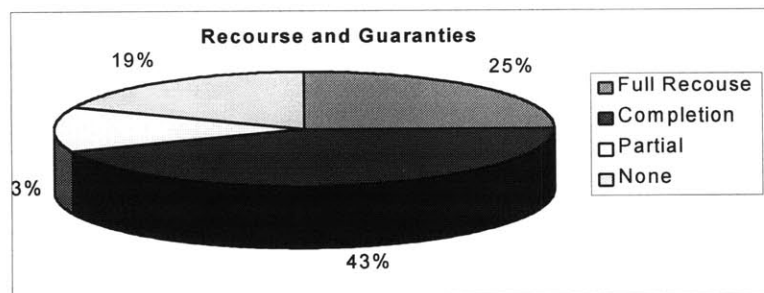
Over 62% of the projects had no pre-leasing requirement and only 6% had any type pre-leasing requirement at all, typically 25-30%.

Figure 8



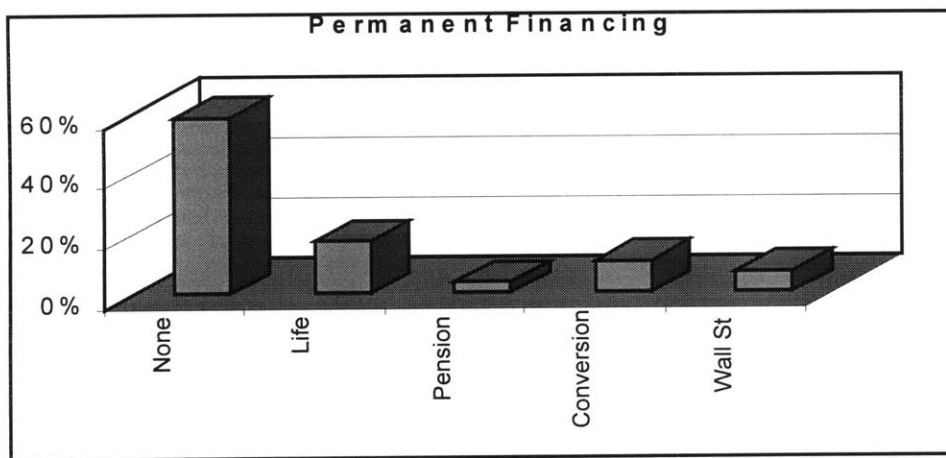
Guarantees of some form were required from 90% of the Borrowers, however, only 25% full recourse and 43% were completion only. The remaining 3% partial recourse.

Figure 9



Finally, almost 60% of the projects had no permanent financing arrangements in place. Of the permanent loans in place, 27% were issued by life companies, 27% were conversions provided by the construction lender, 18% were issued Wall Street lenders, and 9% were provided by pension funds. An additional 18% were standby commitments issued by life companies.

Figure 10



These findings certainly raise some concern about the future of projects currently in development. Each of the next three chapters of this paper will focus on a single issue that was raised as a result of the survey findings. The objective was to integrate the survey findings with other industry literature to obtain a current perspective on the market.

The first issue to be discussed, sources of capital supply, describes suppliers of capital for real estate investment, the second issue, underwriting standards, looks at the affects of capital supply and the last, the exit strategy, addresses the risks that developers are undertaking with regard to permanent financing.

CHAPTER 4

ISSUE ONE: SOURCES OF CAPITAL

In a recent article Anthony Downs, who has been tracking development activity in his National Real Estate Investor column for the past several years, said that there are three reasons for the recent increase in development activity.¹¹ First, continued demand for additional commercial property space generated by the nation's still burgeoning prosperity. Second, absorption of vacant inventory created by 1980s. Rents and prices are surpassing levels needed to make new development feasible. Lastly, the commercial real estate markets are flooded with financial capital looking for something in which to invest. In another article Downs commented that as long as investment officers get paid to make deals, the temptation to put money out, despite increasing evidence overbuilding, will be irresistible.¹²

Banks are competing with Wall Street to issue debt in order to maintain fees and record earnings levels. Pension funds are trying to offset immense increases in their portfolio weighting in stocks caused by rising stock values. And REITs are buying property to increase their total capitalization level and to continue to show growth in FFO. While the first and second explanations provided by Downs are certainly valid reasons to initiate development, the third factor that is noted is certainly not. That being said, we will now proceed to address the primary

¹¹ Anthony Downs, A national commercial real estate building boom is underway, National Real Estate Investor, October, 1997

¹² Anthony Downs, National Real Estate Investor, April 1996

objective of the survey presented in this paper, which is to gauge the amount and character of capital currently available in the market.

The survey involved not only a determination of the source and terms of financing committed but also a discussion regarding the number and types of capital sources that were under consideration to fund the construction project. The developer was asked to identify the source of construction financing by category (e.g traditional bank, conduit, or opportunity fund) as well as to indicate the terms and source any permanent financing that had been secured. General comments regarding the availability of capital were also solicited and one respondent who preferred to remain anonymous stated that the amount of capital chasing projects is mind-boggling. On the debt side, providers include regional and money center banks, life companies, conduits, investment banks, pension funds and most recently mortgage REITs. On the equity side investment banks, opportunity funds, REITs, private investment funds, pension funds and private investors as well as an onslaught of foreign capital, are all chasing transactions. In the next section we will look at some of these participants as they relate to the findings of the survey.

Banks

The survey results indicated that 66% of the construction financing was provided by traditional banks. However, in almost all cases the developer had considered more than one source of capital. Often, several traditional banks were pitted against each other in direct competition for the developers business. The traditional banks that appeared to be most active and visible on the national construction lending scene included BankBoston, Fleet, NationsBank, PNC, Marine Midland and KeyBank.

A recent Merrill Lynch report estimated that the vast majority of new commercial development projects are being funded by lenders, many of which have CMBS lifelines to the capital markets. This is an interesting comment since it implies that lenders, concerned about maintaining their securitization pipeline, may begin to reach for yield in less familiar territory. The report went on to suggest that real estate lenders often base their credit decisions on current property market conditions rather than on what conditions are likely to be in 12-24 months ahead. ¹³

Developers seem to be well aware of the level of competition in the market and using it to their advantage. The survey results indicated that although developers have a strong desire to maintain prior banking relationships, they continue to obtain quotes and term sheets from a variety of lenders. Eugene Ludwig, former Comptroller of the currency recently reflected on this subject. He stated that examiners are hearing too many bankers say that they are making loans which, in the best case would yield little or no profit, but are making them anyway out of fear that the customer may be lost to the competition. ¹⁴

It may also be that competition in the capital markets has created an overall homogeneity in pricing. In more than one instance a developer commented that the banks' awareness that a Wall Street lender was also looking at the deal had contributed to an improvement in the pricing the bank was prepared to offer. Wall Street firms just make it more difficult for us to compete in the

¹³ Eric I. Hemel and Leonard G. Sahling, Tracking Major Office Markets in the U. S., Merrill Lynch, January 30, 1998

¹⁴ Charles Stein, Banking, Bad Loans, Boston Globe, April 24, 1998

marketplace.¹⁵ In other words, the tremendous amount of competition is creating an overall climate that is more favorable to the borrower.

It appears that many banks are attempting to enhance their product line to offer a variety of debt and equity services in order gain competitive advantage and to prevent clients from looking elsewhere. A recent survey by National Real Estate Investor indicated that leading commercial banks are now offering a wide array of financing alternatives, including construction loans, miniperms, bridge financing, mezzanine debt and REIT financing. Examples of this are First Union's announcement to develop a one stop shopping approach for commercial real estate customers and NationsBank statement that it wants to be known as a company that can do it all, construction lending, miniperms, bridge loans, acquisition loans and takeout.¹⁶ These new product offerings provide banks with new sources of fees that contribute significantly to earnings.

This activity raises some concern regarding the capabilities of the personnel that are required to administer these new product lines. In addition, many of the banks most active in the construction lending market have established satellite offices to increase geographic coverage with the establishment of new outposts in unfamiliar markets. Ed Blakely who is a Senior Vice President Commercial Mortgage Origination with Wells Fargo stated that with stable markets and increased liquidity, as we go forward into 1998 and beyond there is a risk of overbuilding.

¹⁵ Steve Bersman, Commercial banks fight Wall Street for CMBS deals, NREI, March 1998 p. 56-64

¹⁶ Steve Bersman, Commercial banks fight Wall Street for CMBS deals, National Real Estate Investor, March 1998 p 56-64

Wells Fargo is based in California has 16 offices throughout the country and expects to originate \$11 Billion in mortgages in 1998, compared to \$7.5 Billion in 1997.

Pension Funds

Pension Funds remain one of the largest long term providers of capital to the real estate market; however, their capital has recently taken on new forms of investment. While the survey found that pension funds provided only 3% of the permanent financing, further investigation revealed that pension money was also involved in the development process in more subtle ways.

As discussed previously, academic research conducted in the late 1970's and 1980's strongly compelled pension funds managers to allocate as much as 10% of their portfolios to real estate investment. Advisors who have traditionally invested directly in long-term private debt and equity manage the majority of these funds. Recently however, with the recovery of the market, pension funds have begun to take a more aggressive posture on real estate investment.

A conversation with Geoffrey Dohrmann, Publisher and Editor in Chief of the Institutional Real Estate Letter indicated that there appears to be confusion among pension funds regarding the appropriate strategy concerning real estate investment. While pension funds continue to provide a tremendous amount of capital to the real estate market, it has manifesting itself in new forms of investment. Some pension funds have allocated a substantial portion of their portfolio to investment in real estate securities, believing that the public markets will provide similar returns with less overhead, more liquidity and better ability to estimate market value. Other pension funds have taken on a more aggressive strategy involving opportunity funds. Dohrmann

estimated that some pension funds are currently allocating as much as 50% of their real estate investments to opportunity funds.

Opportunity Funds

While the survey indicated that 8% of the construction financing was provided by opportunity funds, their participation in the general market seems to be much larger. As of July 1997 institutions and high net worth individuals had invested more than \$18 Billion in some 50 opportunistic funds. In 1997 alone, opportunity funds expected to have some \$8.5 billion in equity available, that will be leveraged as much as 75%, providing the ability to purchase and develop as much as \$34 billion of real estate.¹⁷ This equity is primarily being provided for mezzanine debt and equity for the new development.

The \$24 Billion Colorado PERA, \$69 Billion NY State Teachers, and \$29 Billion Virginia Retirement System all have either invested a significant portion of their portfolio in new development projects or have committed to a fund that will.¹⁸ However, many in the industry believe that fund managers will have increased difficulty finding enough high yielding real estate investments to satisfy the large amount of capital that has recently been committed to this sector. There are simply more fund managers competing for a limited number of good opportunities, in a market with less upside.

¹⁷ Kim Dougherty, How Long Can They Last, A Look at the Opportunistic Fuel Gauge as Investors Keep Piling into the vehicle. The Institutional Real Estate Letter, July 1997, Page 7

¹⁸ Terry Williams, Big Funds invest in real estate development, Pension and Investment, April 20, 1998

Another developer that responded to the survey commented that the scary thing that is going on is you have a lot of investors, pension funds, REITs and opportunity fund that are reaching for yield. And due to the rise in property prices created by aggressive acquisition on the part of REITs, a lot of the opportunity funds deciding to develop properties as opposed to buying. The opportunity funds are in the market today providing the equity capital to developers and conventional banks doing the construction loans¹⁹. Increased competition for development opportunities is pushing investors into thinking about more aggressive ways to invest which leads to speculative development and it seems to be getting a little late in the cycle for the amount of new buildings that are coming on line

Another pension fund manager said that although he has begun to see a slow down in demand, which has caused him to begin to close the door on new development, he still believes there are two good years left. Dohrmann, who reports on pension fund activity for his publication, is so concerned that he has initiated a survey of his own.²⁰ He is currently tracking the development activity of 14 opportunity funds. Although he has only preliminary figures, the numbers are large enough to cause considerable concern. He estimates that some pension funds are have allocated as much as 50% of their real estate portfolio investment to opportunity funds, and that those funds have committed from 15% to as much as 50% of that capital to new investment.

¹⁹ Terry Williams, Big Funds invest in real estate development, Pension and Investment, April 20, 1998

²⁰ Geoffrey Dohrmann, Publisher and Editor in Chief of the Institutional Real Estate Letter

Insurance Companies

The survey confirms industry reports that insurance companies are much less involved in the real estate markets today than they have been in the past. The survey results indicated that insurance companies did not play any role in providing construction financing; however they did provide permanent commitments for 10% of the projects and standby commitments for another 7%.

Insurers liquidated large pools of non-performing real estate assets during the 1990s and were slow to re-enter the whole loan market. Reinvestment in long term assets was less attractive than in the past due to the fact that customer preferences had changed from long term whole life policies to term insurance, dramatically altering the liability structure. In addition, as a reaction to past losses, insurance regulators significantly increasing risk based capital requirements for direct real estate investment. Investments in real estate equities and whole loans are now subject to a 30% capital requirement compared to a .3% requirement for high grade bond investments.²¹ Therefore, although some insurers such as Teachers and Northwestern Mutual remain committed to real estate as an asset class, we should expect traditional real estate investors including Aetna, Prudential and Travelers to continue drastically shrinking their real estate portfolios.

In place of direct debt and equity investments, many insurers have contributed assets to REITs in return for equity shares and have liquidated whole loan portfolios by issuing CMBS, retaining the highest rated securities. Many view this as a positive change since insurers were often characterized as inefficient and bureaucratic, and criticized for suffering from a herd mentality when it came to real estate investment. In addition, their exit from the private market does not

²¹ Bowen McCoy, Real Estate Capital Markets: A New Paradigm?, Real Estate Issues, December 1997

seem to have created any type of a shortage of capital. Rather it has merely contributed to the shift of capital from the private to the public market.

A developer commented that anyone looking for money in commercial real estate industry doesn't need to search very hard these days. I've been doing this for 21 years and there's more capital than I've ever seen in this business²² Now even the life insurers are originating loans for Wall Street, however, if they get a creampuff they will keep it for themselves, if not they will securitize it.

Wall Street

Much has been written about the rapid growth of the public real estate markets and the blurring of boundaries between traditional lenders and Wall Street capital providers and the survey results confirm the strong presence of Wall Street in real estate capital markets. Of the construction projects that were surveyed 21% received construction financing from Wall Street. Although only 17% of the takeout commitments in place were provided by Wall Street, comments from developers indicate that this percentage is expected to increase in the future, as more projects secure permanent financing. Currently conduit loans and mortgages made directly by Wall Street lenders are the primary sources of securitization product for CMBS issuance. The general sentiment of those that had not secured permanent financing is that the strength of the CMBS market will continue to provide ample opportunity to secure takeout financing at favorable rates upon completion.

²² Barney, Wolf, Midwest Real Estate News, October 1997

On the debt side, of the \$1.3 trillion commercial mortgages outstanding, roughly 14% is securitized and the rest are placed with traditional banks. However, as a result of establishment of conduits, the balance is shifting. In 1997 over \$44 Billion in commercial mortgages were securitized. This was a 48% increase over 1996 and the consensus seems to be that securitizations in 1998 will exceed \$50 Billion. Product is coming from refinancing of existing mortgages and to a certain extent new construction.²³

Conduits were developed by Wall Street in response to the credit crunch of the early 1990's. Their primary function is to originate and warehouse mortgages until such time that sufficient volume has been committed to create a security. The conduit market has contributed greatly to the standardization of the commercial loan process, which has enabled participants to gain significant operating and pricing efficiencies. These efficiencies have benefited borrowers by lower the cost of capital and reducing turnaround time.

As the market for real estate securities continues to grow it is important to remember that the creation of CMBS does not reduce the underlying risk of the asset. It is the investor, not the issuer or underwriter, that ultimately bears the risk of loss. Joseph Franzetti, Senior Vice President with the rating agency Duff & Phelps, indicated that the increase in CMBS activity has effectively improved the mechanics of the underwriting process through improvements in the exchange and processing of information. However, there are so many people in this game that we are clearly at the point where we may have gone overboard in some cases and we won't

²³ Phoebe, Moreo, The new financing tool, FASIT, Journal of Property Mangement, September 17, 1997

actually know who is doing a good job originating until the next cycle.²⁴ Many feel that the recent introduction of a new securitized investment vehicle, the FASIT, will only increase the risk of abuse.

FASIT

In September 1997 the federal government passed legislation enabling a new asset backed security vehicle, the FASIT. Although quite similar to the REMIC structure, the FASIT can include all types of short-term assets and allows for assets to be added and removed following the issuance of the securities. Under the REMIC structure an asset change would require the structure to be dissolved and new underwriting and documentation to occur; therefore, the added flexibility of the FASIT is anticipated to provide greater efficiency and lower costs. Proponents of the vehicle also claim that it will provide a mechanism for managing interest rate and prepayment risk through investment in hedging instruments such as swaps, options and futures.

The FASIT creates new opportunities in the market for financing all types of commercial real estate, particularly the potential to create greater liquidity in the construction loan market. The FASIT is expected to be used to further expand developers' access to capital and to meet the increasing investor demand for mortgage backed security investments. Joe Franzetti referred to the FASIT as the Golden Goose, which we are going to squeeze until all the eggs are out. He cautioned that we would use the FASIT structure to securitize construction loans and 'hide some

²⁴ Ben Johnson, Changing Roles, competition heats up U. S. capital markets, National Real Estate Investor, April 1997

other things”, since the sponsor can substitute anything they want (bad loans) so that the buyer can never really understand the performance of the originator²⁵.

The results of the survey seem to confirm that the FASIT has not yet been embraced. There remain a few issues to work through before widespread demand for the FASIT is expected. The first obstacle is that the party transferring assets into the FASIT structure may be required to pay taxes based on the value of the cash flow as established by the IRS, rather than the based on the actual income from the transaction, as is the case with the REMIC.²⁶ The second issue is that securities issued through FASITS can only be purchased by C corps, which are taxed at the corporate level; and some of the largest B-piece buyers, mortgage REITs such as Criimi Mae, do not qualify. However, once Wall Street works through these issues, use of the FASIT structure should be closely monitored.

Mezzanine Debt and Leveraged Equity

While only 3% of the survey respondents specifically identified the utilization of mezzanine debt or leveraged equity it is a subject worth discussion. In the mezzanine mortgage sector, which provides second mortgages and preferred equity generally spanning the 75-90% portion of the capital structure, there were at least 29 different providers at last count.²⁷ And the number of investors providing pure equity continues to grow and far exceeds the number of mezzanine providers.

²⁵ Ben Johnson, Changing Roles, competition heats up U. S. capital markets, National Real Estate Investor, April 1997

²⁶ No Stampede to Use FASITs, Commercial Mortgage Alert, September 22, 1997

²⁷ Michael Baucus, Choosing Your Bet Options When Office Building Financing Gets All Green Lights, Development Magazine, September 1997, page 26-27

While the yield on mezzanine debt has moderated significantly, generally falling to 17% IRR; some institutions will provide equity for a yield as low as 12% or less. In addition, lenders are using points, exit fees, varied pay rates, participation in cash flow and residuals to achieve desired yields. An example of this type of transaction was the arrangement of a \$200million LOC for General Growth properties by a Wall Street bank. The funds were used as equity to acquire sites for the construction of 13 shopping malls. The equity was leveraged by another \$560million in construction financing on the properties. The mortgages were subsequently bundled together and securitized.

REITs

The survey results indicated that 13% of the construction projects were being undertaken by REITs. Of those who responded to the survey, 80% used unsecured corporate debt and equity to finance development while the remaining 20% used secured debt provided by a traditional bank in the form of a collateralized mortgage.

Until very recently REITs that have pursued rapid growth strategies have been rewarded by investors who have bid up stock prices to levels reflecting large premiums over NAV. Although this growth has come predominantly in the form of acquisitions, as purchase prices have continued to climb, REITs have given more consideration to development and/or establishing joint venture arrangements with third party developers. Now the REITs which have suffered from a decline in their stock prices have turned to the debt markets to fund the development and acquisition of new properties.

REIT stocks have declined as much as 10% from year end 1997 and investors now appear to be regarding them as income stocks as opposed to growth stocks. The concern is that with fees from REIT equity issuances on the decline, Wall Street and money center banks are quickly stepping in with unsecured debt to continue the flow of capital for direct acquisition and development, despite the message being sent by investors.

With the average value of REIT shares falling 9% in the first 6 months of 1998, many REIT executives are unwilling to pay for new purchases with stock that they consider undervalued. Instead, they're adding debt. Public debt offerings by REITs more than tripled in the first 5 months of 1998, from \$2.2 Billion to \$7.2 Billion .²⁸ The Federal Reserve, recognizing this trend, recently warned the nation's banks to shore up their lending standards and singled out loans to REITS as posing new risks. Banks' exposure to REITS has risen sharply in the past year, with many institutions increasing lending to that market by hundreds of millions of dollars, often unsecured.”²⁹

Some argue that since the role of REITs in financing new construction amounts to only about 20% of total activity, limiting their access to capital would probably only modestly reduce the number of newly started projects.³⁰ REITs however purchased 70% of the property sold in 1998, and therefore, their acquisitions are essentially establishing cap rates and loan to value

²⁸ Barbara Martinez, REITs Adding new Debt to pay for Acquisitions, Wall Street Journal, June 24

²⁹ John Wilke, Fed Warns Banks on Lending Standards, Wall Street Journal, July 1, 1998

³⁰ Eric I. Hemel and Leonard G. Sahling, Tracking Major Office Markets in the U. S., Merrill Lynch, January 30, 1998

ratios. Therefore, although most lending institutions are still limiting LTV's to 75% and DSCR to 1.15+, property prices (values) are being driven upward ahead of rents³¹. If REITs cease to acquire at the same levels, lenders are going to have a tough time justifying property values and loans placed against them.

³¹ Eric I. Hemel and Leonard G. Sahling, Tracking Major Office Markets in the U. S., Merrill Lynch, January 30, 1998

CHAPTER 5

ISSUE TWO: UNDERWRITING STANDARDS

The above comments and survey results provide strong evidence that there is an abundance of capital in the market. Based on this information, the next issue to be addressed is the effect that this increased supply of capital is having on the terms and conditions of financing. This chapter seeks to identify current trends in underwriting standards through the comments of industry regulators, capital market participants and actual financing transactions.

The following anecdotal evidence has been compiled to provide insight on the current state of the financing market. In a recent forum regarding competition between Wall Street lenders and banks, one participant indicated that as a result of increased competition he has seen a liberalization of terms and conditions, as well as a reduction in pricing, on all products from construction to miniperm³². In another example, a mortgage broker indicated that the office market is so hot that lenders are funding development of office properties on a speculative basis³³. He then provided the following examples of recent transactions to add credibility to his claim. As a result of depth of competition to provide construction financing, a developer of a speculative office building was able to secure construction financing at 85% of cost with no pre-leasing at a rate of Libor +200bp.³⁴

³² Steve Bersman, Commercial banks fight Wall Street for CMBS deals, National Real Estate Investor, March 1998 page 56-64

³³ Michael Baucus, Choosing Your Best Options When Office Building Financing Gets All Green Lights, Development Magazine, September 1997, p 26-27

³⁴ Michael Baucus, Choosing Your Best Options When Office Building Financing Gets All Green Lights, Development Magazine, September 1997, p 26-27

In a second transaction an investment bank provided a forward mortgage commitment for 100% of the cost of a partially pre-leased office building, indicating that that the commitment was based on the strong projected cash flows of the project. Having a firm takeout commitment in place the developer received a construction loan for 100% of cost. Therefore, provided that the developer completes the building, he will own 100% of the project without having to invest any capital. The phrases that should be focused on in this deal are “partially pre-leased” and “strong projected cash flow”.

This type of activity has recently drawn the attention of the regulatory community. In fact, Richard Spillenkothen, senior bank regulator at the Fed called this a critical time for banks to maintain their credit discipline. He also provided evidence, based on a comparison of loans originated in 1995 to loans originated in 1997, that intense competition for loan customers has lead to a sharp decline in lending standards. As result of the study the Fed recommended strengthening written standards and procedures including using a forward looking analysis and stress-testing loan terms to ensure performance under adverse economic conditions,³⁵

More recently, Andrew Hove, FDIC chairman reminded lenders that loan growth and increased competition are the typical reasons that banks reduce their underwriting standards. The FDIC conducted its own research and found that underwriting practices, especially involving construction and commercial real estate loans, should continue to be monitored carefully.³⁶

³⁵ John Wilke, Red Warns Banks on Lending Standards, Wall Street Journal, July 1, 1998

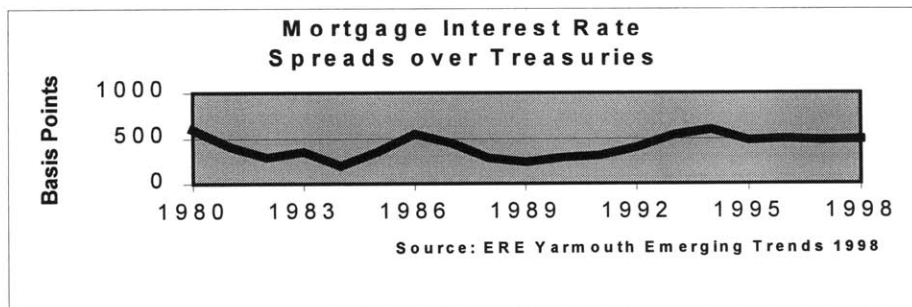
³⁶ George Green, FDIC Raises Concerns about Construction and Real Estate Lending, Commercial Investment Real Estate Journal, March 1998, p. 8

In another report, Julie Williams, Comptroller of the Currency, concluded that banks are being driven by competition and pressure to boost earnings, and are risking trouble by relaxing lending standards. The deterioration in credit underwriting standards we are seeing in the banking system today is serious and more lenders are accepting greater risk of loss without compensation for the level of risk assumed. In short, too much money is chasing too few good loans, competition is fierce, and memories fade.³⁷ Clearly those that are charged with regulatory oversight of the credit market are concerned that in the face increased competition suppliers of capital are having difficulty maintaining an adequate level of discipline.

Pricing

Developers are reporting that construction financing has not been this generous for a decade. A host of new lenders from insurance companies to Wall Street firms are competing with local banks for the attention of developers. And as a result, yields on construction financing have probably dropped 120 to 150 bp over the last 2 years, from Libor +200-225 (10 Yr Treasuries + 280-300), now at Libor +150bp.(10 Year Treasuries + 230 bp)³⁸

Figure 11



³⁷ Michael Schroeder, Comptroller Adds her Voice to Concerns Over Slide in Banks Lending Standards, Wall Street Journal, July 11, 1998

³⁸ Steve Bergsman, Financing & Money Matters, Shopping Center World October 1997

observation of yield compression was also confirmed by the survey results. The overall average price of the construction loans from the survey was Libor +168 bp. However, this average reflects pricing on projects financed earlier in the cycle at Libor +225, while more recent projects averaged Libor +150bp and financing for build to suits projects were as low as Libor+120bp. Clearly this confirms industry reports that due to increased competition pricing is strongly trending down.

Since a justification for this type of price compression could also be an equal and simultaneous improvement in underwriting standards, the survey also focused on the specific areas of pre-leasing, equity contribution and guarantees as an indication of the strength of underwriting standards.

Preleasing

As mentioned earlier in the discussion on risk of construction loans, one very effective method of reducing risk in the construction loan process is to increase the pre-leasing requirement of a project. While 32% of the survey indicated a significant amount of pre-leasing or a build to suit situation, shockingly, 62% of the projects has no pre-leasing requirements at all. This is particularly troubling since there is strong evidence to suggest that the market is nearing its peak and could face a slowdown in demand if economic conditions change. The remaining 6% of the survey respondents reported that lenders required minimal pre-leasing of between 25-30% prior to funding of the construction loan.

Anthony Downs reported that the degree of purely speculative development is rising rapidly. He continued by saying that experience proves that when motivated by conditions like those now prevailing, developers will build far more space than their market requires, even if each knows that others are starting projects, which will add up to overall surplus.³⁹ Basic optimism and egotism of all developers, qualities necessary for their success, lead them to conclude that their projects will succeed.

With minimal or non-existent pre-leasing requirements developers are entering very uncertain territory. Excesses of the 1980's are finally being absorbed and demand in most markets is just starting to reach the point where increases in rental rates occur. In addition, trouble in Asia and recent economic indicators are suggesting that the potential for economic slowdown is becoming more of a reality. The question now seems to be will it be a gradual slowdown or a sharp decline. Perhaps this will depend more on whether developers eager to get back in the game and lenders anxious to stay in the game will exercise enough discipline to maintain the supply demand equilibrium. Furthermore, if market fundamentals are indeed as strong as developers and lenders purport, then new construction projects should conceivably enter construction with much higher incidence of pre-leasing, whether it is required or not.

Equity Requirements

If a project fails to meet its projected cash flow due to slower lease up, lower rental rates or higher expenses, it is the equity contribution on the part of the developer that then becomes

³⁹ Anthony Downs, A national commercial real estate building boom is underway, National Real Estate Investor, October, 1997

important to the ultimate success of the project. The survey results indicated that 17% of the transactions did not require any equity contribution by the developer, while another 31% of the projects required only a contribution of land. In these instances, land represented 10% or less of the total project cost. Another 27% of the survey respondents reported that the financing source required the contribution of land and cash, resulting in an estimated total equity contribution of 20% or less of the total project cost. The remaining 24% of the projects required anywhere from 20-40% equity contribution. There did not, however, appear to be a direct relationship between the perceived risk in the project and the equity requirement.

These findings are of great concern since it is the equity component that typically motivates the developer/borrower to persevere if oversupply or decreased demand occurs. It should also be noted that increasingly borrowers are taking on subordinate debt, reducing equity and incentive to stay around if trouble hits.⁴⁰ Shrewd developers can finance out new projects with mortgage funds supplemented with money from high yield equity investors. Many developers can once more undertake new projects without putting any of their own capital at risk, which will surely motivate many to undertake high-risk projects.⁴¹

Although many survey participants indicated that Wall Street lenders were willing to provide construction financing as favorable terms, they elected to finance elsewhere as they were reluctant to commit to permanent financing as part of the deal. Wall Street lenders clearly seem

⁴⁰ Anthony Down, Is the Construction comeback becoming a building boomlet, National Real Estate Investor, February 1997, p 32

⁴¹ Anthony Downs, A national commercial real estate building boom is underway, National Real Estate, Investor, October, 1997

to be willing to provide aggressive construction financing as a means of developing a securitization pipeline.

Conduits players have been tightening the time frames for a deal and reducing the time for underwriting. It is not unusual for an investment banker to take a pool of mortgages to a rating agency. The agency will then sample the portfolio and if one loan (property) has a problem it will be replaced. The problem loan will then be placed in another pool where the hope is that it won't be sampled again.⁴² This technique has not gone unnoticed by the developers, who as a group appear to be very skillfully playing Wall Street lenders against banks to obtain more favorable pricing and terms.

Another manifestation of equity contribution is Loan to Value Ratio Wall Street Lenders are aggressively lending at better rates and with higher LTV to bring new product into the securitization pipeline, and development lending seems to be a large part of their strategy to increase whole loan securitization. For new construction loans Wall Street firms are generally lending 5 % more of construction costs than commercial banks and 5-10% more of stabilized value. However, they may also require a commitment for the permanent loan to provide securitization.⁴³

It is worth noting that LTV calculations are merely a reflection of underlying appraisals of property value. One of the most serious criticisms of the appraisal profession is its reliance on

⁴² Midwest Real Estate News, October 1997, Barney Wolf

⁴³ Steve Bergsman, Shopping Center World, October, 1997

the past to project future value; rather than to anticipate future changes in property markets. Therefore, it is important not only to focus on reported statistics but to also consider the underlying assumptions that are being used to arrive at appraised values.

If you believe that the market is near its peak, then loan underwriting is being based on peak financial performance, providing little protection to providers of capital. Some banks are again making construction loans for more than 100% of actual construction costs, based on generous appraisals.⁴⁴ One study indicated that actual LTV ratios calculated by rating agencies have been as much as 17% higher than the figure reported in prospectuses⁴⁵. Generous appraisal values should also be of great concern to investors in CMBS, since they ultimately bear the risk of default

The combination of higher property values and lower interest rates has enabled owners to borrow more against the same cash flow. The result is much more leverage on a per square foot basis.⁴⁶ When the market begins to turn, it will be this type of underwriting that will dramatically impact the severity of losses.

Guaranty

The survey results indicated that only 25% of the loans required full recourse, 43% of the loans required only a completion guaranty and 19% were non-recourse. The remaining 3% of the

⁴⁴ Anthony Downs, Is the Construction comeback becoming a building boomlet, National Real Estate Investor, February 1997, p. 32

⁴⁵ Steve Bersman, Commercial banks fight Wall Street for CMBS deals, National Real Estate Investor, March 1998 p 56-64

⁴⁶ Ben Johnson, Changing Roles, competition heats up U. S. capital markets, National Real Estate Investor, April 1997

projects required only a partial guaranty, such as the payment of debt service as well as a portion of the principal or some other form of credit enhancement.

Guaranties are another way for lenders to ensure that the developer will remain committed to the construction project. Therefore, banks under competitive pressure to reduce equity requirements, should negotiate to increase guaranty requirements in lieu of equity. However, this negotiation becomes very difficult when other lenders in the market are offering non-recourse financing at similar terms. Not surprisingly, if other options are available, the developer no longer feel compelled to voluntarily pledge their confidence in the project by placing his personal assets and reputation at risk. A recent survey conducted by the FDIC indicated that nearly a quarter of the banks frequently wrote loans on properties without commitments for sale or lease and that a significant number of those loans were non-recourse loans.⁴⁷

Since the majority of guaranties reported in the survey were completion guaranties, we will limit the discussion to that particular type of guaranty instrument. Furthermore, although the terms and conditions of a completion guaranty can be vary greatly; without the ability to review the actual guaranty documents, the generally accepted form of the instrument will be relied on. In this case, satisfaction of the completion guaranty is achieved if and when the developer delivers a completed building. Completion is typically defined as meeting the plans and specifications included and approved by the lender as part of the construction loan documents.⁴⁸

⁴⁷ George Green, FDIC Raises Concerns about Construction and Real Estate Lending, Commercial Investment Real Estate Journal, March 1998, page 8

⁴⁸ Alvin Arnold, Construction and Development Financing, Warren Forham & Lamont, Boston, P. 4-267

In most cases, and unless specifically required, this type of a guaranty does not require that the building be leased or occupied. This is an important distinction since by requiring only a completion guaranty, the lender is placing a great deal of faith in the commitment of the borrower and in the strength of the market to ensure the delivery of an income producing asset. Many financial institutions suffered enormous losses during the 1980s' due to the fact that they often found themselves in a position where the only collateral they could rely on to obtain recovery of their loan proceeds were partially complete and untenanted real estate.

When determining the value of a completion or repayment guaranty, its collectibility should also be considered carefully. Although not entirely, collectibility of a guaranty depends greatly on the credit of the party of that has issued the guaranty. During the 1980's many lenders did not rely on the principals of relationship lending and later discovered that the guarantees they obtained were "not worth the paper then were written on".

The increase in non-recourse lending is more troubling due to the fact that there is evidence that increased competition in market has caused some lenders to consider making loans to less credit worthy borrowers. In fact, one Wall Street lender seems to have developed this type of activity into a specialty product, calling it "transitional capital". In their own words, they are taking loans for what you could call "in the ditch developers", providing them with enough capital to create critical mass, so that ultimately they can access the public markets.⁴⁹ Joseph Franzetti, Senior Vice President, Duff & Phelps also noted that borrowers with less than favorable track

⁴⁹ Ben Johnson, Changing Roles, competition heats up U. S. capital markets, National Real Estate Investor, April 1997

records back in the game.⁵⁰ Joe Rubin, managing director of EYKL real estate group noted that the market has become so heated and awash in capital that even borrowers with troubled backgrounds are finding it easy to line up financing, adding that “ the deterioration of underwriting quality is no longer a question, it’s a reality

Richard Mulebach, president of IREM, suggested that lenders are the gatekeepers of the development process and that they must have the strength to turn a deaf ear to the siren song of the developer. He estimates that office construction has more than doubled in the last year and believes that the issue is not if overbuilding will occur, but to what degree.⁵¹ Surely he would be encouraged by the philosophy of Robert Wilmers, M & T Bank, who stated that owners who bear the full risk of loss make better regulators than regulators. Wilmers stressed that 90% of M & T’s employees are stockholders and the board of directors controls 25% of the company’s stock. He also indicated his support of relationship and arms length lending by saying “It is much more difficult to do dumb stuff in your own backyard”.⁵²

Rating agencies argue that declines in the quality of individual loans have largely been offset by the increased size of conduit deals. Bigger pools allow greater property and geographic diversification, which reduces the risk of loan losses and therefore, the need for higher subordination levels⁵³ However, pressure placed on financial institutions to put out money is intensifying, and they are once again shifting the incentives they offer their personnel towards

⁵⁰ Ben Johnson, Changing Roles, competition heats up U. S. capital markets, National Real Estate Investor, April 1997

⁵¹ Anonymous, Discipline, research can minimize the effects of real estate cycles, Real Estate Weekly, Dec 1997

⁵² Anonymous Wall Street Journal Wednesday July 11, 1998 page A19

⁵³ Anonymous, Warning Signs Flash on Credit Quality, Commercial Mortgage Alert march 16, 1998

emphasizing “making deals” more than “acting prudently”. Those incentives are what caused irrational lending and equity financing practices in the 1980’s and it could happen again.⁵⁴

Based on these comments and results of the survey, there is no evidence that the introduction of the public markets to real estate has increased market discipline. Rather, the increased appetite for CMBS product may actually be contributing to a deterioration in underwriting standards. However, we will have to continue to watch the reaction of investors and Wall Street to determine if this holds as the demand for real estate changes.

⁵⁴Anthony Downs Is the Construction comeback becoming a building boomlet, National Real Estate Investor, February, 1997, page 32

CHAPTER 6:
ISSUE THREE: THE EXIT STRATEGY

In many regards the most troubling conclusion reached based on the survey was the absence of an exit strategy for the newly constructed property. The results of the survey indicated that 59% of the respondents had made no arrangements for a permanent takeout of the construction loan. And although the overwhelming majority of these respondents had high expectations for a sale of the property upon completion, only 3% of the developers indicated that a contract for sale of the property had been executed.

Of the remaining 31% of the survey participants who indicated that they had secured permanent financing, 33% of the takeout commitments were reported to be provided by the construction lender in the form of permanent loan conversions options. An additional 33% were issued by life companies, 22% were provided by Wall Street lenders, and the remaining 11% of permanent financing was to be provided by pension funds.

The rates offered on takeout financing were predominantly fixed at spreads over 10 year treasuries ranging from 125 basis points to as high as 165 basis points. As may be expected, the lowest rates of 6.5% and 6.9% were offered by a Wall Street lenders, while the highest rate, of 7.33% and 7.66%, were offered by life companies. The majority of these loans also had 5 year lockout provisions with yield maintenance and the terms ranged from 10 to 30 years.

Another 7% of the survey respondents had secured a standby commitment. In most instances the developer arranges for a standby commitment when he anticipates the ability to obtain more favorable loan terms upon completion of the project. Therefore, the standby lender is viewed as a lender of last resort, an insurance policy of sorts.

While approximately 8% of the projects in the survey were build to suit, only 50% of those projects had permanent financing arrangements in place. In addition, although several projects reported the presence or requirement of pre-leasing; there did not appear to be a direct correlation between the ability to obtain permanent takeout loan and a desire to secure financing. Some developers with projects that did not indicate pre-leasing had secured takeout financing while other developers of projects with pre-leasing indicated that they elected not to commit to financing prior to construction.

To provide more perspective, the results of this study can be compared to an informal survey of the “top commercial lenders” conducted by Greystone Realty Corp. That survey found that 80% of the lenders offered construction financing at 85% of total cost or 75% of projected stabilized value.⁵⁵ In addition, 90% of the lenders indicated that they would make construction loans without permanent takeout in place and 80% said they would make both the permanent and the takeout.

When the developers in the survey were questioned about the absence of takeout financing, 34% of the respondents stated that they were reluctant to make arrangements for permanent financing,

⁵⁵ Steve Bergsman, Shopping Center World, October 1997

which would conceivably include the payment of commitment fees, because they expected to be able to sell the asset at completion. At the time of the survey, only 8% of these developers had actually identified a purchaser, while another 5% had agreement to accept an equity partner upon completion. When asked who they expected the potential purchaser to be, the overwhelming response was a REIT. The confidence being exhibited by construction lenders and developers appears to be very reminiscent of the last real estate cycle when construction lenders, anticipating a limited investment period, were forced into the position of permanent lender.

REITs as Potential Purchasers

Although REITS are directly responsible for only a tenth of the new building now underway, they are also generating demand for real estate assets through third party arrangements.⁵⁶ It is difficult however, to quantify their full level of participation in the market due to the lack of disclosure required regarding formal and informal purchase contract. According to Paul Adornado, a real estate analyst at Paine Webber, REITS often structure joint ventures with developers where they agree purchase property in advance of construction. However, because REITS are not required to disclose that type of information it is very difficult for investors and analysts to determine just how much development activity is occurring. Until these requirements are changed it will not be possible to generate accurate estimates regarding the prevalence of this type activity.

Developers willing to sacrifice some of their upside may structure this type contract in order to ensure that they will have a purchaser for the property upon completion. This type of forward

⁵⁶ Anonymous, American property Reheated, The Economist, February 21, 1998

purchase contract is typically structured to require the transaction to occur at the time the project meets income of leasing objectives. The price that is paid is most commonly based on a capitalization of income at a predetermined rate. For purposes of obtaining more favorable financing it is advantageous for the developer to obtain a written contract, however, a verbal agreement is often viewed to be sufficient when similar transactions have recently been completed between the two parties.

Ben McGrath, Managing Director, Chase Securities, noted that private equity players, are currently focused on the private markets and are counting on a “future, more vibrant capital market for their exit strategy.”⁵⁷ In other words, developers anticipate that the REIT market will continue to be a purchaser of new product. Another developer added that he doesn’t enter into any investment without thinking about a potential exit that involves the public markets. “ They become the ultimate exit source for the things that we’re doing.

Since 70% of the property acquisitions that occurred in 1998 were completed by REITs; they are setting the cap rate⁵⁸. The public market has introduced liquidity to the real estate market however, it is not without its tradeoff, which is volatility. According to industry observers, if the capital markets are going to control their investment pace and limit unnecessary development, its up to Wall Street analysts, rating agencies and researchers to tell them when to stop. The notion that developers will develop as long as they get the money to build still seems

⁵⁷ Ben Johnson, Changing Roles, Competition heats up U.S. capital markets, National Real Estate Investor, April 1997

⁵⁸ Eric I. Hemel and Leonard G. Sahling, Tracking Major Office Markets in the U. S., Merrill Lynch, January 30, 1998

to hold true. Investment bankers as well as advisors, will push vehicles and earn fees as long as investors will buy.

It's the public market analysts that may provide a level of watchdog objectivity the industry has always lacked.⁵⁹ Perhaps the most dramatic example of imposed restraint were the comments heard at a recent NAREIT forum where REIT managers told analysts and investors that their buying binges were over. By way of example, Spieker Properties Inc, stated that it is in the process of selling "a couple of hundred million dollars worth" of buildings outside its core West Coast markets and Crescent indicated that it will spend the next six months identifying assets that are ready for "harvesting"⁶⁰ This change in sentiment is expected to ultimately have a dramatic effect on the developers who have product in construction. Kennedy Associates, a pension fund advisor that develops and then sells property, said that until a few months ago REITS had purchased 50% of the properties it sold. Now however it seems as if Wall Street has taken away the key to the vault.⁶¹

Are Developers Getting the Message

Some property owners report that REITS have become less aggressive in buying properties. However, it is unclear whether developers, in their eternal optimism, truly believe that the recent changes in the REIT market will effect them.

⁵⁹ Sally Gordon – Real Estate Capital Markets: Who's the Daddy?, The Real Estate Finance Journal, Summer 1998 p5-13

⁶⁰ Neal Templim, Leading REITs Prepare to Sell Off Properties, Wall Street Journal, July 2, 1998

⁶¹ Neal Templim, Leading REITs Prepare to Sell Off Properties, Wall Street Journal, July 2, 1998

In particular, office development has staged a vigorous rebound. If recent acceleration in office development continues unabated during the current year, occupancy rates in many markets could begin to weaken by late 1999.⁶² Cities that appear to be highly susceptible to weakening are Atlanta, Charlotte and Columbus. The aggregate development pipeline for the 33 office markets studied by Merrill Lynch contained three times as much new space in fourth quarter 1997 as it did six months earlier: 74 million square feet as compared to 26 million square feet on a base of 2.6 Billion square feet. The recent pickup in new construction has been widely dispersed across the U.S, however it has been concentrated in the suburbs. Newly delivered space will amount to nearly 50 million square feet in 1998, approximately 2% of existing inventory, and far above the 30 million square feet that was projected just six months prior. Seeing development pipeline triple in six months has shaken our confidence

A specific example to the extreme optimism being exhibited by developers is the return of development activity in Dallas. The Dallas market is one of a few markets that has recently received attention due a potential for overbuilding. At this time last year there were three or four buildings under construction, now there are 31.⁶³ The “Bid D” is currently building 10.5 million square feet of office and 17,000 apartments. During the 1980’s, 80 million square feet of office space that was constructed in Dallas.⁶⁴ Although Dallas has benefited from becoming a major

⁶² Eric I. Hemel and Leonard G. Sahling, Tracking Major Office Markets in the U. S., Merrill Lynch, January 30, 1998

⁶³ Ben Johnson, Dallas leaders unanimous: Development is now King, National Real Estate Investor, October 1997

⁶⁴ Neal Templin, Dallas Economy Booms, Topping Atlanta, Wall St. Journal ,July 6

⁶⁴ David Kirkpatrick and Neal Templin, REITS lose their Bull –Market Bounce, Wall Street, June 19,

distribution and high tech center, there is a question about its ability to maintain the pace of recent growth and the risk of once again establishing a rather undiversified economy.⁶⁵

⁶⁵ David Kirkpatrick and Neal Templin, REITS lose their Bull –Market Bounce, Wall Street, June 19,

CHAPTER 7

CONCLUSION

The results of the survey and the comments provided by industry participants confirm that currently there is no shortage of capital or financing alternatives in the real estate market. However, it is still unclear whether the increased capital availability is due primarily to a rising demand for space or if it is purely the result of a growing desire for real estate investments

There is sufficient evidence to suggest that the increased competition among the suppliers of capital is contributing to yield compression and a loosening of underwriting standards. Of particular concern is the observed decline in pre-leasing and equity requirements, the absence of permanent financing, and the return of non-recourse lending. Furthermore, the lack of additional collateral support and required guaranties does not appear to be based entirely on the strength of the property market.

Although banks remain the primary source of construction financing, the presence of Wall Streets lenders and opportunity funds, is substantial enough to mention and is expected to continue to be strong. The threat of losing market share to these less traditional sources of construction financing has substantially improved developers' ability to negotiate favorable terms and has even created the availability of capital for the development of speculative projects.

To date there does not seem to be strong evidence that the public market has strengthened the discipline of the real estate credit markets. Rather, by providing an endless supply of capital for securitizable whole loan product, it may actually be contributing to the further deterioration of underwriting and yields. Important questions remain regarding the incentive structure of the lending and securities market and whether capital market participants have sufficient motivation to exhibit discipline if demand slows.

The survey also confirmed that the majority of projects in development were proceeding despite the absence of a clear exit strategy. Developers continue to remain optimistic regarding a sale of the property to a REIT, despite the fact that softness in the REIT market has caused the acquisitions pace to slow considerably. Others remain confident that continued demand for CMBS product will provide ample opportunity to secure permanent financing upon completion.

There seems to be enough evidence to cast some doubt on the belief that the introduction of the public market will eliminate real estate cycles. However, we will have wait for the economy to show signs of a slowdown before we will be able to determine if decreased demand will cause developers to cease construction regardless of the availability of capital or if the public markets will react to a economic slowdown by restricting credit.

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