

How the subprime fallout affects development
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Randhir Sahni is president of [Llewelyn-Davies Sahni](#), a Houston-based urban design, planning and architecture firm that he has directed for the past 30 years. He is also a registered investment adviser and has run Sahni, Inc., his investment advisory firm, for the past decade.



Sahni says that the confluence of his two disciplines gives him an understanding of the role of capital in development and an insight into some of the more far-reaching effects of subprime lending.

Mortgage Insider quizzed Sahni about how he sees the subprime crisis affecting developers.

Q. You've said that the subprime fallout will effectively retire the current generation of developers. What do you mean by that, and why?

A. The typical developer gets into the business to make the most money in the least amount of time, and have the least amount of risk/exposure while doing that. When he sees that the conditions are right to bring about "affordability," he begins the development/building process.

The cycle ends when any number of factors might cause the money supply to shrink, and the developer then backs off from the resulting exposure and risk. If he's seen a financial gain by that point, chances are that he will move on, rather than wait 7-10 years until conditions are optimal again.

The people at the head of large development firms have lots of incentives including performing clauses that are part of their contract. They'll look at those incentives as being very attractive in light of the present market situation and changing conditions of the economy. If these developers started with virtually nothing, and now they have a few million in cashable equity coming to them if they leave, they certainly attempt to retire.

In 1986, Congress' tax law accelerated many such retirements. Now we're seeing the subprime lending situation accelerate a new wave of retirements. The common element is: cost and availability of money. When the profits decline, for whatever reason, people move on.

Q. How will this change developers' view of real estate and affect their future expectations? Is that equally true in Orange County, or is the situation different here?

A. It will actually affect them in a more severe way, since development rules in California are so much more restrictive than in some other parts of the U.S. Land use designations can't be changed as easily there as in, say, the Houston area, where I do business. So, Orange County developers will have to find a way to increase absorption and some compromises will have to be made.

As the dollar declines in value – or has been declining – the materials coming from overseas will go up in cost... and people won't be able to afford the same house for the same amount of money.

So, we're going to see a new breed of developer enter the landscape – one with a new set of parameters under which he or she think they can make a profit. It would only be speculation to say what such parameters would be, but I suspect that we'll see things like densities going up (as regards how many houses you put on an acre),

and square footage of rooms coming down. I would anticipate a reduction in amenities, as well. For example, I think that the \$1,200 washer/dryer combo installed in a tract home may be a thing of the past.

Of course, this is only temporary. In seven or eight years it will all come back.

Q. Here in Orange County, a handful of developers have already announced that they are delaying plans to build. How does a situation like this affect planned developments and master plans?

A. We are seeing this, as we speak, and will continue to see it happen, because “absorption” has diminished substantially. Affordability is going away, so people can’t afford to buy all the houses that are sitting on the market. And in California, they may have to sit longer before affordability returns.

Let’s say you’re a developer and, at the height of subprime lending, you could get \$300,000 for a completed house. Well, now you can only get \$260,000 because the interest rates have gone up and the buying power has accordingly shrunk. So, you cannot produce the same house, as you cannot sell it for the same price. This affects how the developer thinks while dealing with cash flow. They come back to the drawing board and say, ‘Do we build smaller houses? Do we build on narrower lots?’

About 35 percent of every development goes into roads and open space. So if you can increase the density – which means “jam” in more houses on the same amount of land – you get a better return. In that case, the same amount of street and the same amount of open space serves a greater number of houses, so the return goes up. So, yes, it’ll have physical implications but the degree will depend on the nature and intensity of the restrictions imposed on the land. Since severe land use restrictions are prevalent in Orange County, developers of these areas will not be able to follow their game plans to build a certain number of houses in a certain year. They are going to have to scale back. Development delays are sure to happen.

Q. What land-ownership changes have occurred as a result of the subprime crisis, and why are they important?

A. I am not up-to-date on land transactions in California, but the phenomenon of less affordability will certainly have an impact on that market.

What I think is more interesting to look at, is the fact that a lot of overseas money has come and gone, and this has happened before when the dollar was weak. In the 80s it was Japanese developers that invaded the U.S. when the yen was strong and bought a great amount of real estate in Hawaii. In the 90s it was the oil barons that came and bought property all over the country. And now it’s going to be the Chinese, Canadians and Indians. So whoever has the money will come to take advantage of the situation.

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

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

Q. What is the long-term effect on banks and lenders in terms of their willingness to back development projects?

A. It has affected their confidence severely because the banks are under scrutiny, now. And all the individuals working for the banks making money are under scrutiny, and so they are not going to lend the way they used to. They will be more careful at lending as the standards have changed, including more fees and points, etc., to make sure there’s enough money to cover any losses... or any mistakes they make.

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