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The Other Side of Subprime

The Fallout of the Subprime Lending Crisis for Developers

By Randhir Sahni

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

Retiring a Generation of Developers

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

History shows this is a cyclical trend, and the cycle ends with the cost of long-term money rising, causing the supply to shrink, or when the Fed raises the rate, thereby tightening the money supply. When that happens, the developer backs off from the resulting exposure and risk. If at that point, he has achieved his financial goals for the effort, chances are he will move on.

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

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

Planned Developments and Master Plans

A developer, at the height of subprime lending, might have received $200,000 for a completed house, depending on the market. Now they might only get $160,000 because interest rates have gone up and buying power has shrunk accordingly. They cannot produce the same house because they cannot sell it for the same price. This affects how the developer thinks while dealing with cash flow. They have to come back to the drawing board and ask: "Do we build smaller houses? Do we build on smaller lots? Do we wait and reduce inventory,thus carrying costs?"

For the developer, the subprime fallout will certainly have physical implications and things will change considerably over time. About 35 percent of every development goes into roads and open space. So if 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 and the return goes up.

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

Crisis of Confidence Among Banks and Lenders

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

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

Resolution Trust Corp. to salvage the S&L and the real estate industry.

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

A New Breed of Developer

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

At the height of subprime lending, the sort of developer we saw was someone looking to turn a quick profit and who was able to offer affordability to the would-be homeowner because money was so inexpensive. As the cost of money came up and affordability went up, they realized it didn't cost much more to build more house. We started to see more houses with three, four and five bedrooms; larger bedrooms; kitchens that came with all the latest and central air conditioning. The houses started to bloat. As the interest rates came down and cost per month came down, people began to buy bigger houses on the same housing budget.

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

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

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

The other thing that will be interesting to note is the flush of overseas investment money that enters the market, which has happened before when the dollar was weak. In the 80s, it was Japanese developers that invaded the United States when the yen was strong and bought a great amount of real estate in Hawaii and the 48 states. In the 70s and again 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. MBD

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