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Is there a 2007 opportunity in the residential / condominium market?

mh Michael Hart

Tremont Realty Capital

At this time last year we noted that after several years of producing stellar returns, largely attributable to continuing cap rate compression, income producing real estate was fully valued in comparison to the stock and bond markets. Achieving adequate risk-adjusted yield by investing in stabilized income producing real estate was an ongoing challenge in 2006. Further exacerbating the inherent difficulties; cap rates have remained below long-term interest rates, thus making positive leverage a general impossibility in the short term. Consequently, leveraged returns from newly acquired, high quality assets that have compromised the core of portfolios held by substantial investors have remained in the single digits.

Inventors seeking to avoid the trap of buying at a cyclical value peak and frustrated by such unattractive returns have, in the last year, increasingly sought higher returns through investing in development and redevelopment projects. Participating in the value created through the entitlement, construction and marketing process by investing early in the real estate life cycle has been viewed as an attractive means to achieve enhanced portfolio returns.

Among the property types that large investors have found particularly attractive as investment targets in the last several years are condominium projects. No other segment of the residential market has received as much attention. For example, investors could (in theory at least) make attractively priced mezzanine loans to developers constructing new residential condominium projects or converting existing apartment properties or other types of real estate into residential condominium complexes. Mezzanine loans of this character have typically been priced at rates ranging from the mid-teens to as high as the mid-twenties dependent on security, the perceived probability of success in the development process and the relationship in the capital stack that the mezzanine loan holds relative to underlying construction financing and equity contributions from a development entity. The theoretical projected returns on these loans have appropriately exceeded the returns from making equivalent loans on existing, income producing real estate. As lenders quickly found out, the hope for higher returns came with significant additional risks associated with a) dramatic increases in labor and materials construction costs and b) the general overbuilding that resulted in deteriorating sales prices and absorption. These issues were exacerbated in many markets by a plethora of small private investors speculating in residential real estate in a variety of ways.

People still need places to live, and will generally continue to seek to buy in lieu of renting. There may be a significant current opportunity in the residential/condominium market for larger investors who recognize that although the market is damaged in some ways, the rampant speculation of small unit investors and "flippers" has been erased for the time being.

Recently, one of the most discussed issues among major participants in development has been the rapid increase in projected project costs. Such increases are primarily the result of constantly escalating labor and material costs. The ability to commence construction is nearly always dependent on securing a commitment for construction financing. Lenders, of course, demand the delivery of executed pre-sale contracts accompanied by deposits from end buyers. Direct lenders and intermediaries have witnessed unanticipated increases in labor and materials costs of as much as 20-30% during the planning stage. These projected increases are often incurred on a continuing basis during the predevelopment planning phase. Typically, significant developer capital has been expended to secure entitlements, in doing development planning and in related soft costs.

In some markets the recognition of projected costs increases during the pre-development planning period has caused some participants to back away and necessitated the deferral of project commencement and the return of buyer deposits. The general result of suspended project starts resulting from cost escalation during pre-construction periods should be less severe overbuilding than might normally be expected at this stage of the residential markets. However, a great many projects have gotten off the ground and are nearing completion despite the aforementioned issues, perhaps in large measure because of the pressure that institutional investors have had to get capital invested in real estate and the consequent erosion of underwriting standards. Many projects have been started foolishly because someone was willing to invest and because many developers, given the availability of easy financing, could not resist the temptation to commence construction even with the knowledge that their planned project might not be economically viable. Yet, lender vigilance has led to maintenance of consistent quality standards during construction.

The rapid run up in residential condominium values and the corresponding buying frenzy in the period 2001-2005 has led to the current significant downturn in sales velocity. Could we soon witness the end of a short term real estate slump that has been exacerbated by the overbuying that resulted in some ways from mistimed overbuilding? Has this resulted in an opportunity to invest in failed or marginally profitable new projects or groups of new units that have long term intrinsic value? If so, is there an investment strategy in the residential sector that might make sense?

There is a compelling arguement to be made that the cyclicality endemic to residential real estate development is, this time, being exacerbated by increasing projected costs in the period between project conception and construction commencement and this factor as much as any is changing the more traditional dynamics of supply and demand. Further, it seams that intellegent investors can make smart selective buys in the residential sector right now.

As much as "location, location, location" is used as the end-all determinant for smart real estate buying we argue that at present, the concept of "timing, timing, timing," is equally important. 2007 may be shaping up as a good time to buy recently completed blocks of residential condominiums since developers are motivated to discount prices in order to clear inventory. While each market has its own supply/demand dynamic it is clear that in most markets across the country it has become a buyers market. Some markets require patience as they will experience a more extended recovery due to ongoing deliveries from rampant new construction. In these instances we will likely see significant additional discounting as projects completed. If prices dip below pre-sale contract levels and buyers elect not to close there will be a temporary downward spiral in prices as developers attempt to stem losses. In any event, in the short term a substantial buyer with ready capital should be able to make outstanding purchases of blocks of units on a heavily discounted basis.

What better time to buy could there be for the investor capable of making mass purchases of blocks of residential condominiums? Most "end buyers" have begun to assume the economy will not go into recession, but believe it will take 2007 and part of 2008 to absorb the over supply and being a new cycle of price appreciateion. If the latest reports of slowing GNP and low inflation continue, it is logical to assume that the Fed may actually lower interest rates in 2007. A trend of low interest rates would be conductive to stable economic growth and would further cushion the repricing of residential assets, thus providing a soft landing to the housing market after a shallow and short lived correction. Even if the Fed does not lower rates adn values do not correspondingly, rebound purchasing in mid-to-late 2007 should continue as people still need new places to live and will sooner rather than later re-enter the market. Developers are operationally constrained by excess inventory and cannot easily pass through the cost increases they have in many cases already incurred. Understandig that nothing is ever so simple, it certainly looks like a short term buying opportunity is approadching.

So, for a significant investor who can afford to make a short term bet that residential pricing is approaching the stabilization point after a short-lived, albeit significant decline in prices, right now could be a great time to buy blocks of condominium units, achieving a volume discount on pricing, eliminating the misery of the developer, and at the same time beating the end buyer/user back into a market that should start to appreciate it again in the not too distant future.

Michael Hart is a senior director at Tremont Realty Capital, Chicago, Ill.

Tel: 781-878-4540 / Fax: 781-871-1853 / 800-654-4993 / nerej@rejournal.com / www.rejournal.com