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Real estate development process: A slippery slope, made steeper - by Daniel Calano

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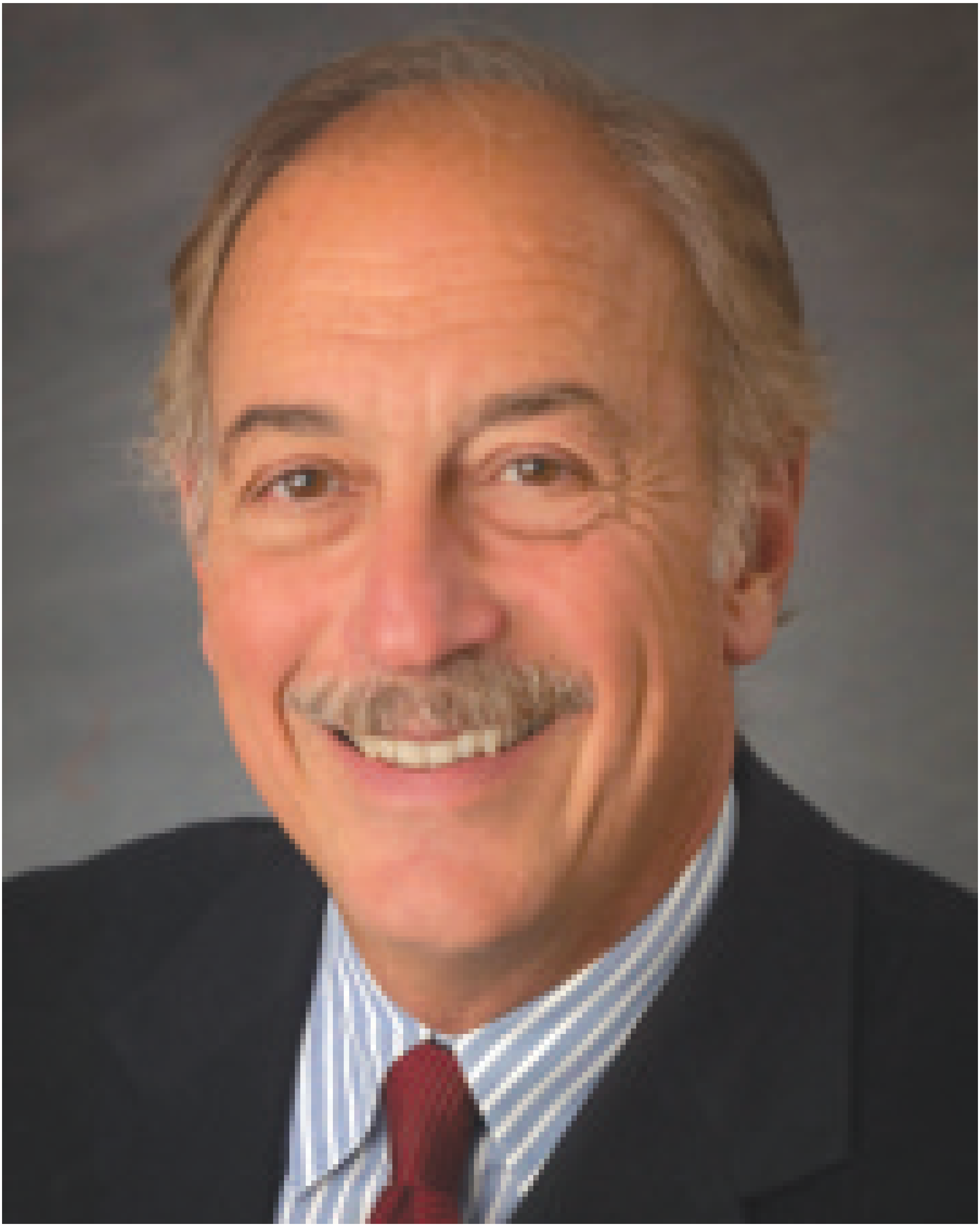

Daniel Calano

A recent March 2023 McKinsey and Company report indicates that real estate developers are pausing, or even canceling, development projects that were otherwise ready to go. In some cases, projects already under construction have been stopped.

As I have written about before, the reasons are obvious, including higher interest rates,higher capitalization rates and thus lower values, labor and materials inflation, and potential over-supply. All that said, delaying a development project that was ready to go is a difficult and extreme measure, not to be underestimated.

The development process is already a slippery slope, meaning that once you step forward, it is difficult to stop. First, good sites are hard to find, and once selected, purchase is often a swift step forward to be competitive. Second, planning and permitting a project, after purchase, requires at least two years of intensive planning and legal work. Once permits are in hand, the construction process itself requires typically two years or more. Once built, while it varies, rent- up is often another two years. In all, a project can take a decade to reach stability and profitability. Once you're in, you have to be all in. Once you step onto the slope, it is very difficult to stop.

Thus, "pausing" a project is a very big step. The development process is a process of eliminating variables. Once a good site is selected and purchased, the initial cost is mostly fixed. But, the next step of permiting is extremely variable, and not done until it's done. Financing is set only in the present moment and thus variable in the future. In this marketplace, projected costs are mostly variable throughout the process. The future is uncertain, and the ability to fix variables and move forward is different from the past. As a result, pro formas from a few years ago are inaccurate, if not meaningless.

All this said, some developers will take the unusual step of slowing or canceling the project. The developer who can proceed in this environment must be well-funded, well-planned, with a large enough portfolio of projects to move ahead with some, and delay some others. Even those who meet these criteria are becoming more cautious, as they recognized the difficulty of pinning down some of the variables. It may also be finished in a completely different environment then anticipated, adding the potential risk of oversupply. The risks are high, and the product may not produce the profit needed.

The McKinsey report suggests that developers should take various creative steps, outside the usual process, to be successful in this environment, such as: working closely with clients/tenants, not just producing physical spaces; seeing opportunities throughout a project's lifecycle; focusing on operating efficiency, not just income. I would add working to extend permits and working closely with lenders and partners. These are fresh and creative pronouncements, sometimes already in process. It suggests a revamping of older processes, and an embracing of new ones. Those who can take these steps will undoubtedly be more successful than those who don't.

Daniel Calano, CRE, is managing partner and principal of Prospectus, LLC, Cambridge, Mass.