

New York City Housing Development

Suffers the Effects of the Credit Crisis

Following is an abbreviated and edited transcript of a panel discussion on October 2, 2008 at Massey Knakal's Madison Avenue offices

Panelists, Clockwise from left:

Kenneth S. Horn, President, Alchemy Properties

Andy Gerring, Managing Director, Development Marketing Group,
Prudential Douglas Elliman

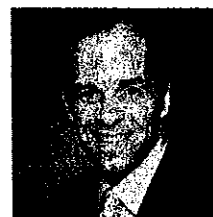
Paul Massey, CEO, Massey Knakal Realty Services

Matthew Gottsegen, Partner, Franke, Gottsegen, Cox Architects

Matt Albano, GCP Capital Group (not pictured)

Moderator

Larry Sicular, Editor, *The Stamford Review* (not pictured)



Sicular: I'm the editor of *The Stamford Review*, and we're here for a panel discussion this morning on residential development. With us are our host, Paul Massey, of Massey Knakal, a building brokerage firm; Andy Gerring of Douglas Elliman development marketing; Matt Albano of the GCP Capital Group, a real estate financing company; Matthew Gottsegen of Franke, Gottsegen, Cox, Architects; and Kenneth Horn of Alchemy Properties, a housing developer. It's hard not to start without talking about what's happening in the present uncertain environment, so I thought we'd perhaps ask Matt first to talk about the availability of money.

Albano: The real transition that we have seen in the finance market is the uncertainty of actual closing. Getting a term sheet used to mean a lot more than it does in these days.

Sicular: What is a term sheet?

Albano: A letter of intent. Initially, I draft a financial brochure, with the developer's materials; we meet on site, negotiate with lenders and pick a lender to proceed with. At that stage, the bank has done a lot of underwriting, it likes the economics of the deal and wants to go forward, so they issue a letter of intent. That letter of intent is not a commitment. Then we do a formal appraisal, a project cost review; we pretty much go through all third parties to make sure budgets work and the individuals' economics for guarantees work.

Sicular: What's changing that now?

Albano: It's very hard to get commitments. In the past I would get someone a letter of intent to go through that process, get them to a comfort level, and the bank would close—almost 99.9 percent of the time they would close. I've never seen it put on cruise control but the obstacles were far less.

Sicular: We're talking about construction loans?

Albano: Absolutely, ground-up construction loans. I just had two particular deals and a letter of intent and

both of them got bounced. One was from a Hong Kong bank, which had a recent bank run or attempted bank run, so that affected all commitments. Another one is a Puerto Rican-based bank, which I'm still waiting on, but it looks like it's going south.

Sicular: What kind of time frame are we talking about?

Albano: I'm talking the last two months. And the basic terms of financing have changed too. They're doing longer terms. Initially, the typical deal was a prime plus one, 18 months with a six month extension. A lot of developers haven't met those deadlines, so now its 24 months which means more reserve, more oversight, more underwriting, less loan to cost. We used to do 80 percent, and sometimes up to 95 percent with mezzanine financing, but that has really dried up. We're now doing 65, 70 percent loans. Your average developer of the last five years is an attorney, like me, architect, or other professional, who understands the business but has not done the amount of ground-up work that some other seasoned veterans have done. Loans for them are pretty much non-existent right now.

Sicular: What are the rates?

Albano: Rates are going up as well. They're doing floor rates now, previously they were at prime plus one-and-a-half, or plus two, but the floors are really going up to seven-and-a-half or eight percent. I'm doing a couple at seven which are still being honored, through a few committees that will still allow condo releases; some of them won't now. Everything has to be rentals.

Sicular: Ken, what are you finding?

Horn: Well, we've closed on two construction loans this year, one in June and one in August. The first loan we closed, the bank did not negotiate. They held the rate at 1.65 above LIBOR, which was really remarkable.

Albano: That's fantastic.

Horn: The second loan we closed on in August. The original spread of the loan was LIBOR-based, and we were offered 70 percent of cost. It did close, but it was a

mild torture. From the term sheet—we didn't actually get a commitment letter—we went right to documents. The spread went up about 30 basis points and we were very fortunate. We were told by the lender that ours was the last construction loan that they were going to do in Manhattan this year. So financing is difficult, to say the least.

Sicular: And can you tell the readers what kind of projects we're talking about for these two loans?

Horn: Both are ground-up buildings; one is a 75,000 square foot building; 18 stories, two units per floor, on the Upper East Side and the other is about 160,000 square feet on Tenth Avenue in the West 50s. I should point out that even though they're condominiums, they make sense as downside rentals. The lenders will only look at lending now based on downside rental scenarios, knowing that in the event the market doesn't hold, they would be in a position to rent the units out, with their debt service covered. I'd imagine that 18 months ago, that was not a great concern.

Massey: Can I ask you to rough out construction costs for those two projects?

Horn: We build our own buildings so we act as our own contract manager, so it's a little bit lower in terms of cost. For the building on East 77th Street, we're coming in probably around \$370 per square foot. Our building that's on Tenth Avenue is only an 8-story building, and spread out over 37,000 feet, so it's a huge site. We budgeted around \$375-\$380 a foot.

Gerringer: Paul, are the owners of the land getting more realistic on the pricing?

Massey: Sellers would prefer not to sell because real value is unknown, and buyers are, to some degree, in that same mindset so it's hard to answer.

Overall, we were selling roughly 50 buildings a month during the sunny days in the first half of 2007, and 15 months ago, 14 months ago we immediately and dramatically dropped to 25-30 buildings a month, so velocity went off depending on the sub market anywhere from 35-50 percent.

So in 2005, 2006 and the first half of 2007, the velocity of New York City properties sales was four-and-a-half percent, so four-and-a-half out of every hundred buildings would roll over.

Horn: But that is not necessarily for development sites; that's for income producing

Massey: All property types were now at two-and-a-half percent. The velocity in development sites went from four-and-a-half percent, in that range, to less than one percent now. In a lot of our sub markets there's no velocity of land or property that would be significantly redeveloped.

Gerringer: And the transaction prices, have they gotten lower or remained steady?

Massey: On sales that are actually happening, which mostly happened in the earlier part of 2008, the prices have held.

Sicular: Are the land deals that have closed clustered in any particular geographic area?

Massey: Manhattan and pockets of high-end Brooklyn.

Albano: With the money out there, I have guys they can write checks for anything. But what they want is to take product over.

Sicular: What do you mean by that?

Albano: Traditional mezzanine financing has now morphed into a JV [joint venture] equity piece. But the guy developing his project doesn't want to give it up. Rather than bringing in a partner, probably surviving, he would rather say no and just take debt. I think the bigger guys are going to come in and be able to pick off a lot of nice pieces. But I don't think we're there yet. But we're coming there in a couple of months.

Horn: In any given week we're approached by probably four guys—not exaggerating—over the last 90 to 120 days. They're saying, "I'm developing a property, I'm out of money, I can't get a construction loan; will you come in a joint venture with me?"

Sicular: Matthew, do you have any comments you want to make about construction costs?

Gottsegen: They are always going up. It seems that even if the purchase price is down, the velocity is slow, and the market is a bit frozen, construction costs are operating on different parameters—you know, they're global.

Gerringer: Until Dubai and China slow down.

Gottsegen: Concrete's up, steel's up. Construction costs, at least at the moment, don't seem like they're flattening out. They may.

Horn: I think on certain of the trades people are getting a little hungry.

Gottsegen: Yes, it seems we have gotten more calls from vendors and contractors looking for work in the last month, dramatically more. For the last two years no one needed to make those kinds of calls.

Sicular: Andy, why don't you give us some kind of overview of the new development pipeline, if any are coming on at all?

Gerringer: As far as projects coming on, a lot of things are on hold. Those guys that did get their financing are at "should I do it as a rental, should I do it as a condo?" We have been recommending to our developers, for as much as a year, that they consider taking deals that are within reason, as they may have to take a lot off later. As a broker you can tell them that 'til they're blue in the face sometimes.

Sicular: We're talking about the end unit sales.

Gerringer: I'm talking about the end unit sales, you know where people come in and make decent offers but the developer wants to hold the price.

Sicular: You saying a reasonable deal, what kind... can you talk in percentage terms?

Gerringer: It really varies. The Manhattan market has slowed up a little bit more than Long Island City, where

we have a lot of product out, and three jobs open, and we've been doing sales. A couple of weeks ago, on the worst day on Wall Street before this past week, we did three sales at our jobs out there. I think part of it has to do with people getting good deals; and they're coming from rentals as opposed to having a house to sell.

Horn: The developer mentality is almost to push the market and our mentality, which Andy recommends and we adhere to, is not necessarily to push the market, but to sell your product, sell it at a relatively fast pace, pay off your debt, return your equity, hit your profit and move on, but because some of the land went for such high prices and because construction costs have gone up, coupled with the minimum release prices from the lenders, it's hard for some developers to be in a position where they say: I'm going to cut my price from \$1,500 to \$1,300 a foot.

Sicular: I want to talk about end-loan financing for the buyers of individual condos and what you're seeing.

Gerringer: Sure, the buyers have to be a little more qualified today than they were. Developers were building and projecting a year, but their developments may have taken a little longer than they thought to complete. For some people who had 90 percent financing the rate lock expired and there's no longer 90 percent financing in the market. So there are some issues with that, and the buyer generally has to be more qualified today. You have to have a job. [laughter] No income verification, no doc loans have gone the way of the dodo bird really, and it's really a different lending environment.

Sicular: Other than in the immediate crisis, in your existing projects, how does your absorption rate this year compared to absorption rates last year?

Gerringer: It's much slower; even in a market that has had very high absorption and visitor traffic like Long Island City, the traffic is at the same level, but the purchasing has slowed down.

Sicular: Can you quantify that at all?

Gerringer: I'd say maybe it's down 20, 25 percent.

Sicular: Ken, what types of projects are you looking for now? You say you're still a buyer.

Horn: Anywhere between 60 and 100 units is perfect for us. And we're looking to buy either rehabs or ground-up opportunities that make sense at not-inflated sales prices, not-inflated rents. The good news is that we've got equity partners who are willing to take the deals with us all cash. We go through the development process, the architectural, engineering, the demolition, probably the excavation and foundation, which will probably end up taking 15 months, to get us rolling with all the permits and DOB approvals, etc. At the end of the 15 month period, we'll make a determination whether or not we'll continue the deal all cash or, hopefully, borrow if the financing markets open up.

Sicular: What do you find the developers are looking for Paul? I understand things are on hold right now, so let's talk about the current cycle.

Massey: We're talking to a whole bunch of our clients about the possibility of middle income, lower income housing. There are three million housing units in the city and the creation of housing has been just one little element of that, the luxury condo market, for two reasons. One, it was highly profitable business, the other was that construction costs and land values got so high, that it was really difficult to contemplate anything else.

Gerringer: That's right.

Massey: For low and middle income, there hasn't been any creation of stock. The last big surge in housing creation was in the 1960s. So our housing is aging; we need rehabilitation of that property. The Bloomberg administration is projecting a million people added to the census over the next 7-10 years, and if you do the math on 2.4 people for every unit, a typical family size, that need alone is 400,000 units.

Sicular: So where do you believe that it's feasible to create low and middle income housing? You must be offering sites to developers.

Massey: The lowest price on a square-foot basis for land

has been consistently in the Bronx, which is something people should consider because it's a fundamentally good place. There is infrastructure; there are communities; there is transportation; and it abuts Manhattan. So I don't know why that schism in land values still exists for the Bronx. I don't think it will continue to exist.

Sicular: Are there projects that are coming on-line up there, or is this just an opportunity that you perceive?

Massey: I think the developers that have been active up there are probably in a little bit of a squeeze, so that's taking a rest, but when the sun starts to come out again, that's an area that people might want to consider for bread-and-butter housing creation.

Sicular: Is this rental housing creation?

Massey: Ideally yes.

Horn: A lot of the Bronx developers have always had 421a certificates to sell, and those certificates buttressed their returns. Now that they don't have them to sell, it'll be interesting to see. ...

Massey: For our readers, the 421a program has been modified by the city. In order for a development to qualify, affordable housing now has to be created on-site, so creating housing in the Bronx and selling the certificates for market rate housing in other, more expensive locations isn't going to be happening any more. I think the city is going to be sorry.

Horn: I agree, the concept was that we shouldn't sell certificates to wealthy people who are just going to have a reduced tax base, however there was a certain cycle to it, in the sense that those certificates helped generate low-income housing.

Massey: The modification of the 421a directly conflicts with the mayor's stated desire to create 165,000 new units in the next few years. So that will have to be addressed.

Sicular: Matthew, let's talk about the design of new buildings, and the designs of unit interiors.

Gottsegen: I think design awareness, as something that's value added to a project, has been gaining a lot of credence. And it's marketed to the point where a specific architect or designer is hyped, like at the Richard Meier Towers, a groundbreaking iconic building in the West Village. And it's been a great opportunity for architects to show that there is a reason for design as value added, not only its stylish aspects, like custom hardware and elegant bathrooms and kitchens but also quality bones, really good layouts, good light, good views, good things that people really desire. The architect's role has ratcheted up somewhat on the high-end projects. What a good designer can bring to the table is looked upon as extremely important and it's marketed to the hilt.

Gerringer: I think Related has done a good job of branding with [Robert] Stern. I think that's an instance where there's some value. Most of the time I don't think it makes that much difference. What people really want in the market today is good value; they want a great layout, they want nice finishes. All these amenities, the wine coolers, and home theaters are all marketing hype. I'd rather not see that kind of thing put into these projects because it all comes down to the bottom line.

Sicular: Because you feel buyers are becoming more conservative?

Gerringer: No, it's about the absolute dollar. We can talk dollars per square foot until we're all blue in the face, but it's meaningless. It's about how much somebody can afford to spend, given today's financing guidelines. At the end of the day you want a great product that somebody can sell at a reasonable price. You know, another thing coming into play that we haven't mentioned is this whole green....

Gottsegen: A lot of condominium developers have stayed away from that.

Gerringer: Ours have for the most part....

Gottsegen: If you're doing high quality, high efficiency boilers for instance, or other kinds of energy saving devices, these are the least sexy parts, because you don't see them. Over the life cycle of the building if you're an

owner and operator, it makes a lot of sense to buy a boiler that will save you oil or gas, but if you're a condominium developer, you're in and out so it's not saving you any money, it's costing you money.

Horn: Back to Andy's point about making units that are theoretically affordable, that is 100 percent accurate. On Tenth Avenue, we've made our one-bedroom apartments a little smaller; we've made them in the high 700s maybe 800 square feet, and what we have also done is to create one-bedroom units with dens, which are about 950 square feet with two baths. So they're like junior twos.

Gerringer: That's a good product.

Horn: And they can be priced well below your standard two-bedroom unit. You could probably sell those for below a million dollars. And you're selling them at \$1,000, \$1,100 a square foot, which is pretty good. There's a cap on what people will pay for a unit.

Sicular: No matter how big it is.

Horn: It doesn't matter, same thing with two-bedroom units. The price per square foot is deceiving although, unfortunately, developers and banks use it as a method.

Sicular: Are the comments you were making about more affordable prices and lower frilled layouts different from a year or two ago?

Gerringer: I think probably two years ago, but you really have to look at who your target market is. What you build in the East Village is not necessarily what you build on the Upper West Side; you really have to know your market intimately.

Sicular: Please explain to the readers what you build in the East Village and how that contrasts with what you build in the Upper West Side.

Gerringer: Generally, in the East Village you would build small one-bedroom and smaller two-bedroom units. You wouldn't build family-sized apartments. They'd be much tighter than what you would build in a more prime location. So a 650-to-700 square-foot, one-

bedroom apartment in the East Village could be 750 to 800 square feet on the Upper West Side. And you do some larger units on the Upper West Side.

Gottsegen: We're doing a project on the Upper East Side that has six 4,500 square foot units. On the Upper East Side it makes sense.

Horn: As a developer I would never do that; it's risky. In the building we're doing on Tenth Ave., we have 95 units. I think I've got four or five three-bedroom apartments.

Gerringer: That's all you need.

Horn: Especially ones, ones with dens, small twos, twos with dens. On the Upper East Side—we have no ones, no studios. They're all twos, twos with dens, threes, and we can combine them and make them fours or fives.

Gerringer: That's the right way. When we work with architects, we recommend that they plan and pre-plan combination units out in advance, wet walls backing wet walls and so on, so if the market so dictates you can change directions.

Sicular: Andy, please explain for the reader how you get involved in a project and where you begin.

Gerringer: The earlier that we get involved the better. We're kind of the developer's outsource marketing department, and we're there through the whole process, from concept to closing. We do the market analysis; we work with the architect and make recommendations on the product design, pricing, reviewing the offering plans, working with the mortgage broker on financing. We're kind of the glue that tries to hold everything together.

Sicular: Essentially the developer is coming to you in part for your knowledge on previous projects.

Gerringer: Yes, and we have also opened up a lot of new markets.

Sicular: What's the most recent new neighborhood for condos?

Gerringer: I'm a big believer in Long Island City. I keep saying this so it sounds like an ad for the Long Island City BID [Business Improvement District], but the reality is you can get from the Jackson Square Station to Grand Central literally in three minutes.

Sicular: All right Matthew, why don't we talk about when developers come to you.

Gottsegen: Smart developers come to us before they buy the property. They maximize profit by building as many square feet as possible. And development properties are sold based on the potential square footage. So we are constantly doing zoning studies for potential clients, showing them how much they can build. That's the first part of the service that we provide.

Sicular: Ken, do you farm out that service? Or do you have it in-house?

Horn: I try it myself at first, and then I give it to our architect and our legal counsel. A lot of times there are discrepancies between the lawyer and the architect.

Gottsegen: Yes, the zoning ordinance is a difficult document to read.

Horn: Special districts, special height restrictions, absolutely. Matt is right; it doesn't matter what the permitted FAR [floor-to-area ratio] is; it doesn't matter how big the site is. You may be in a landmark district, a restricted district. A lot of times when brokers give you the set up, and Paul's guys happen to be very good about this, they will say, gee, you've a 10 FAR, a 10,000 square-foot site, you can build 100,000, but there are hundreds of different variations, and you need your architect and legal counsel to review it.

Massey: Most developers are very bright and have their experts, so they know what they're getting, and they check. And Ken's point is right; there are iterations under the zoning calculation that can surprise people, so...

Horn: In fact, Paul, do you remember years ago we were about to do a transaction, a phenomenal site, and we thought we could build a certain amount, and then our legal counsel remembered something, that didn't appear in the title report, didn't appear anywhere? No one knew it: the seller didn't know it, we didn't know it....

Sicular: What did she remember?

Horn: She remembered that there was some kind of swap of air rights on that site. She said, "I'm going to go to City Planning and double check it," and she was right, we couldn't build anything. So the site was about 5,000, 6,000 feet and we thought we could build 80,000 feet.

Sicular: Wasn't it recorded?

Horn: It was not recorded. It would have been a morass....

Andy: I hope you gave her a good bonus.

Horn: She caught it. Now we've sainted her; whenever she calls, we say St. Melanie. [Melanie Meyers]

Sicular: She really saved your neck.

Horn: Yeah, we had a big group hug in the office... that would have been very bad....

Sicular: I think that's a good place to end, on a positive note. Thanks a lot.