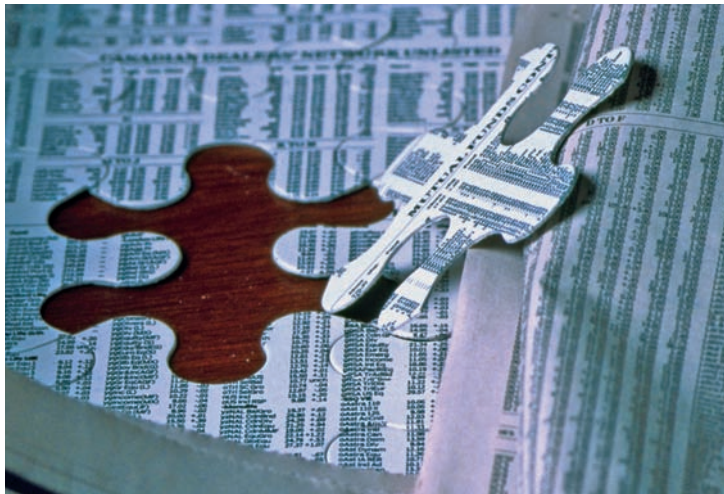


ANTHONY J. TRELLA

Adapting to the New Normal

Success in adapting to today's economic climate will require a commitment to embracing changes in consumer perceptions, capital structures, and real estate product solutions.

THE WORLDWIDE RECESSION of the past few years has had a profound and permanent effect on the real estate sector and all industries engaged with it. Many developing and investing principles that have guided the industry for the past 20 years have been eradicated and are unlikely to be reinstated. New real estate paradigms will be required for planning, entitlement, development, product selection, marketing, and finance.



Emerging is a “new normal,” an economic reset requiring the reeducation of people and the repositioning of business structures and strategies—changes that will go beyond the real estate industry to affect the fabric of American life in a generational shift similar to that seen after World War II. Success in adapting to this new way of doing things will require a commitment to embracing changes in consumer perceptions, capital structures, and real estate product solutions.

In the midst of the current severe economic recession, it is important

to consider the following questions:

▷ How much longer will the federal government be able to serve as the primary—and nearly exclusive—buyer of home mortgages? The recent rise in home sales has been almost entirely driven by the federal government’s intervention in the mortgage industry.

▷ When—and how—will mortgages again be securitized by the private sector? Until there is stabilization in the private mortgage-backed securities industry, uncertainty remains. Consider—and appreciate—the magnitude of the risk should the Federal Reserve Board suddenly end its support of mortgage underwriting.

▷ What new sources of equity and debt financing will homebuilders and developers need, and when will they become available? Hundreds of billions of dollars are now available for real estate development and investment from private/public equity and opportunity funds and recovering central banks. How and when will such funds’ managers invest that capital? When will commercial banks again provide construction loans to homebuilders and land developers?

▷ Will investors accept lower yields from investments in land banking and development—perhaps as low as those available during economic cycles before 1990? Increases in the residual values of land may be burdened by low to no increases in home sales prices, resulting in reduced available returns for equity and debt investments.

▷ When and to what level will interest rates rise? What impact will the increases have on sales absorptions, financing costs, and mortgages?

▷ How and when will impaired community development districts be stabilized? Currently, a significant number of district bond programs nationwide are in default or heading into bankruptcy. For decades, this method of financing has been a major source of capital—as leverage debt—for homebuilders and developers. When will investors again be willing to purchase community development district bonds? Will banks and commercial debt providers possibly take up the slack, given their other constraints?

▷ When will completion/performance bonds become available again? Homebuilders and developers have been required to post letters of credit or completion/performance bonds to warrant the quality of development and infrastructure work. Bonds, normally the favorite choice, were usually provided by the insurance industry, with American International Group (AIG), the global insurance and financial organization, serving as a leading provider. At this time, there is no evidence that a sufficient number of bonds can be obtained to satisfy government requirements.

▷ What will be the ultimate disposition of toxic commercial debt instruments currently held by banks and other investors? Commercial, industrial, and retail real estate appear destined for another decline as their values slip below their underlying debt. Will billions of dollars of commercial debt be reset, or will such debt be sold at deep discounts, resulting in long-term disruptions in commercial real estate markets?

Resurgence of the real estate industry will require its operators and investors to reaffirm the fol-



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lowing maxim: first identify real estate needs in the marketplace, *then* successfully fill them. Doing so will require a level of attention to market data not practiced since before the 1990s.

Foremost is the basic—yet critical—need to identify who will buy, lease, or occupy the real estate under consideration, as well as why, how, and when they will do so.

Practitioners know this as identifying the successful exit plan for development and investment strategies. The consumer remains king and as such will determine the behavior, actions, and performance of the marketplace. The accuracy and thoroughness of the search for the successful exit plan must take precedence over all other considerations. A financial projection driven primarily by desired investment yields and profits rather than by marketplace reality will constitute a cart attempting to pull a horse, and failure will be inevitable.

Numerous tiers of data make up the collective understanding of the marketplace. Some are global in nature while others are specific to local submarkets. The following are a few of the global marketplace issues that deserve consideration in strategic planning, risk assessment, and decision making.

▷ The economic standing of generation Y—known as the echo boomers or millennials, and accounting for 73 million people born between 1981 and 2001—is expected to rise quickly. Many of this group's beliefs and expectations differ from those of their parents and grandparents and will significantly affect real estate structure and use. The impact of this is already being felt and likely will grow geometrically. It is safe to assume that as was the case with their parents, the baby boomers, the needs and desires of this generation will be the primary driver of housing and real estate use for years to come.

▷ Members of generation X—about 45 million people born between 1965 and 1980—are the most affected by the current economic climate, and their previous behaviors and

Generation Trends to Watch For:

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▷ **GENERATION X**—about 45 million people born between 1965 and 1980—are the most affected by the current economic climate, and their previous behaviors and beliefs could change dramatically going forward. Their economic standing is steady and is expected to remain so for at least another decade. Despite their relatively small number, they should have a significant impact on the coming evolutionary changes to real estate products and uses.

▷ **BABY BOOMERS**—about 78 million people born between 1946 and 1964—are also affected by the current economy, primarily in the form of dilution of household wealth and promised retirement benefits, which likely will affect their preretirement and retirement lifestyle plans. Their economic standing is steady, but is likely to begin declining in the future.

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▷ The population of the United States is projected to grow by about 3 million people per year for at least the next 30 years—representing about 18 million more people in the United States by the end of 2015. This

added population will not be evenly distributed across all markets, and where these people settle will vary across city and county submarkets.

▷ About one-third of the annual population growth—1 million people—will be traceable to immigration from outside the United States. This group will arrive with different cultural and social attitudes that will affect the planning, design, and buildout of real estate structures. Many of these differences will run counter to historical trends and the growing expectations of generation Y.

▷ The number of households without children will continue to rise and will affect rental housing as homeownership rates continue to decline.

▷ All real estate, whether already built or future development, will be affected by job growth and the need for new job skills. Where these new jobs are located and the type of jobs they are, as well as the continuing

contraction of other job types, will have the single, most dynamic, ongoing effect on real estate. In addition, the length of the commute to reach these jobs and the relative wages they pay will shape development and guide investment.

The current economic climate has seriously affected the organizational and financial structures of commercial, residential, and industrial development. Similarly affected are the financial institutions and private/public equity and opportunity funds whose businesses are aligned with all aspects of the real estate industry.

Among the major considerations are the drastic reductions in the number of workers available in the construction labor pool, in the supply pipeline of building materials, and in the number of professional support firms, such as architects, land planners, and engineers. The size and timing of the industry's recovery will be tempered by the ability and commitment of such firms to regenerate and grow. Many markets will simply not recover as quickly as the dynamics on the ground would suggest because of this lack of capacity.

History has demonstrated that cyclic real estate recoveries from recessions usually witness the emergence of new homebuilding and development firms. This pattern is expected to return during the coming recovery, which may partly mitigate the loss of so much building and development capacity. But the recovery will take time, it will not necessarily be uniform across all markets, and it likely will be impeded by constraints on debt capital.

A real estate industry in desperate need of change will require new thinking, new process models, new risk/reward models, new financing models, and new collaborations to succeed. People in the industry can no longer afford to believe that a return to the "old normal" is around the corner. The good old days are gone; the future is waiting for those who can embrace and profit from change. **UL**