Construction’s Wrongs

Money Isn’t the Only Anchor That Is Holding Back the Industry’s Performance

By Robert R. Garland and Greegg L. Reneau
Touche Ross Company

With the bank prime rate currently hovering around 15 percent and great uncertainty about future prospects, the problem of obtaining affordable capital for development projects is again a keen one.

Many developments that would have been profitable a few years ago are no longer economically feasible today due to the high cost of money. In addition, today’s real estate executives spend considerable time worrying about the availability of financing and terms.

However, despite high interest rates and uncertainties about capital availability, developers are making record profits and may continue to do so for some time.

Yet the high volatility of recent interest rates concerns Norman MacLeod, vice president of finance of American Savings and Loan Association of Beverly Hills: “We (financial institutions) have the problem that we borrow short and lend long.

“At American, we have a variable rate loan, which permits limited adjustment of the interest rate to reflect changes in the capital market, so that isn’t a major problem for us. But there are still a great many savings and loans that don’t write VRL’s (variable rate loans).

“With short-term interest rates rising and increasing competition from other institutions for funds, this could cause problems for some savings and loans and for their customers as well.”

This situation translates into worries about the future supply of capital in the industry. John Kilroy, Jr., vice president of marketing at Kilroy Industries in Los Angeles, speaks of this concern: “With institutional investors looking to alternative investments—and considering the restrictive nature of usury laws in many states—money is again becoming very scarce. Many financial institutions are now lending only to their ‘prime’ prime borrowers and are not necessarily interested in committing to long-term loans due to interest rate uncertainties.

“Those ‘prime’ borrowers have a healthy financial foundation and past records of success,” explains Kilroy. He adds that smaller organizations, however, could be faced with hard times as available capital becomes scarce.

Even if capital doesn’t become scarce, it probably won’t be cheap.

“I think everyone in our business realizes that the artificial limits on interest rates established by many states are not realistic,” says Kilroy.

“After all, money is like any other commodity—it reacts to the law of supply and demand.”

Nearly all the individuals interviewed think that changes in the nation’s lending and financing programs are imperative if real estate and construction are to avoid costly and inefficient cyclical swings in the future. Alternate mortgage instruments such as the VRL will allow financial institutions to share some of the borrow short, lend long risk with their long-term borrowers, thus stabilizing their loan portfolios.

But those interviewed think that other changes, such as modification of unrealistic usury laws, are still badly needed.

Land Availability

Environmental actions, growing demand, and passage of Proposition 13 in California have put usable land at a premium. Ben Bartolotto, director of the Construction Industry Research Board, explains: “There’s plenty of land. The issue is the availability of land served by roads, sewer capacity, and schools. And with new taxation and spending limitations such as Proposition 13 being imposed by the voters, it’s even more of a problem as local governments are tending to shy away from infrastructure costs.”

“Proposition 13 was a two-edged sword,” says Rocky Tarantello, associate professor of real estate and land economics at the University of Southern California. “On the one hand, it reduced property taxes and kept the rate of change in property taxes at a reasonable level, which, I think, may encourage ownership. On the other hand, because Proposition 13 reduces the revenue-generating capability of the government, administrators are less willing to engage in the kind of improvements necessary to support real estate development.”

Generally, those interviewed think that environmental restrictions have limited the amount of usable land. They also believe that coastal initiatives, environmental impact

Continued on page 22
restrictions, and other laws have effectively eliminated building in many areas and dramatically reduced project density in others.

For developers such as Kilroy Industries, environmental restrictions have had an extremely negative effect. “Initiatives such as the Coastal Zoning Initiative inversely condemn the land,” declares John B. Kilroy, Jr. “Developers have had to carry the property without the ability to develop it. I find this situation irresponsible. It violates the American right to own land and to build on it what you want. While we must have controlled and responsible growth, we can’t overreact by condemning and not rewarding. This type of action can throw our industry into a terrible spasm.”

The decrease in the supply of usable land is accompanied by an increased demand from more people entering the real estate market—particularly the housing market. Because of a basic shift in individual attitudes toward housing, home buyers see housing as more than just basic shelter. They also look at housing as an investment and a hedge against uncontrolled inflation. As a result, people are willing to pay more for housing today. Indeed, the median sales price of new houses now exceeds $61,000—up about $10,000 from 1977.

Because of the greatly increased land costs resulting from a reduction in supply and an increase in demand, developers are now viewing redevelopment and rejuvenation as an alternative to new land development. “There is a trend to rejuvenate and rehabilitate property that is within close proximity to established urban centers which provide a population base and space demand,” notes Brian Hogg, vice president and division manager of development of Coldwell Bank in Los Angeles. “There is now a substantial cost differential between a rejuvenation project and a ‘start from scratch’ building. We foresee a lot of recycling and upgrading of properties. And we expect the same type of return and time schedule for these developments. Redevelopment today is a very marketable product, especially when tenant demand is already evident in an established area. But the problem of finding the right property takes a great deal of time and effort.”

Government Regulation

Government regulation was the most often mentioned (and most emotional) concern of developers. Proposed solutions ranged from complete government withdrawal from any involvement in real estate and construction- to continuance of the status quo. Most of those interviewed, however, saw a more balanc-
ed and coherent policy by government as the critical factor to the continued well-being of the industry.

“Government regulations and controls compound other industry problems and extend development time and cost,” explains Brian Hogg. Not only do government regulations and red tape increase the chance of a project failing, but they also increase the price to the consumer. Many people in the real estate and construction industry believe that the real effect of government intervention is perhaps yet to be felt by developers since recent increased levels of consumer demand have permitted rapid price increases to absorb the escalated costs. What will happen when this stops? Will the developer be asked to absorb these risks?

U.S.C.’s Rocky Tarantello, a proponent of free enterprise, declares: “We must do something to ameliorate the degree of government control. If you trace the legislative history at the federal, state, and local level with the National Environmental Protection Act and the Coastal Zone Initiative, you can see that government keeps creeping into the real estate industry a little at a time. It continues to discourage capital formation and contributes to the marginal productivity of land. The government has imposed real cost increases on consumers and has changed the equilibrium between the developer’s reward and risk. We must remove government from the influential position it currently maintains with respect to environmental quality, building codes, and density requirements. Government has to start removing itself from real estate.”

(Editor’s Note: This is the first of a two-part series by Robert R. Garland, a partner in the Touche Ross Los Angeles office and national services director for real estate, and Greegg L. Reneau, a member of the Los Angeles audit staff. The two Touche Ross specialists interviewed 10 members of the real estate and construction community as background for this series.)