

Whitepaper

Market Opportunities

Capitalizing on Current Conditions while Hedging Risks

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INTRODUCTION

A "Build to Suit" or "BTS" development is one wherein a commercial property tenant enters into an agreement with a developer or landowner to construct a new, purpose-built facility for the tenant tied to a long-term lease commitment from the tenant once completed. Build to Suit development opportunities are historically amongst the market's most popular as well as the most limited investment opportunities. Once an investor understands and appreciates the nature of a build to suit development cycle it becomes apparent why, particularly in bull markets, the opportunity to invest in the build to suit space is limited to long-term market insiders.

Build to Suit developments seek to eliminate the speculative variables that accompany most development projects with the largest and most obvious being entitlements and lease-up. The additional certainty from eliminating these substantial risks compresses the development timeframe and drives attractive annualized returns comparable (on an IRR basis) to more speculative investments.

Sophisticated institutional investors and lenders have traditionally crowded out individual investors in this sector because of the high relative risk-adjusted returns and predictable, repeatable business opportunities afforded. The recent monetary tightening, combined with the persistently slower velocity of capital within the commercial real estate market (a result of the Federal Reserve's efforts to reduce inflation), has resulted in opportunities for investors to capture a share of this attractive development sector and secure long-term gains that are not generally otherwise available.

BUILD TO SUIT SUBSTANTIALLY REDUCES TRADITIONAL DEVELOPMENT RISKS

Build to Suit developments differ substantially from traditional development in several key ways, the most obvious of which is contained in the name – the property is built for a specific tenant or tenants that are both known and committed to lease the property upon completion prior to significant capital commitment. A user, or future tenant, of a proposed property, makes a firm commitment before construction with predetermined scope and lease terms in order to make the project financially feasible. In this way, the tenant, the credit quality, and future income stream are all known up front, which is materially different from a traditional speculative development.

Build to Suit as a development strategy can be used for any asset class. However, over the past 15 years, it has become increasingly popular for retail developments, particularly single-tenant retail. For various market reasons, industrial and multifamily developments have been typically more speculative in nature, often resulting from extensive entitlement and rezoning activities that accompany such developments¹.

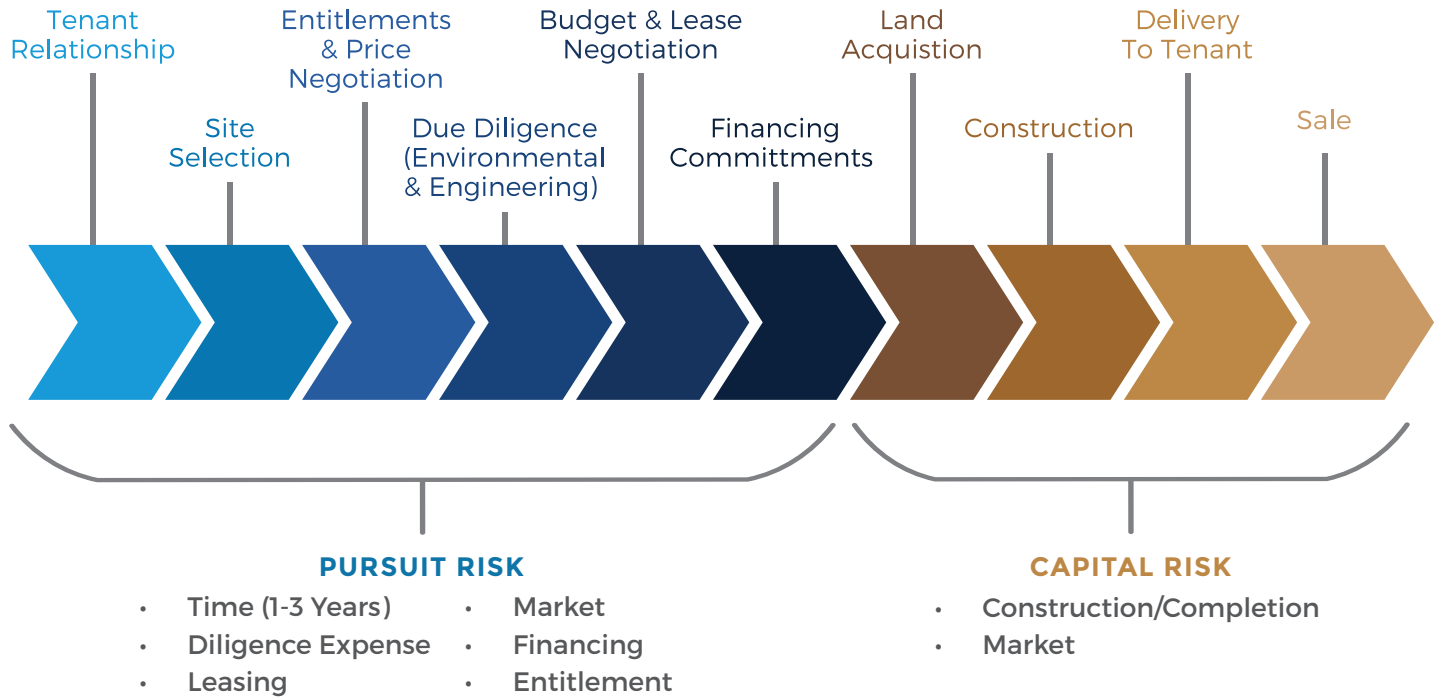
By securing a commitment for the user (tenant) in advance, a build to suit development has a known, fixed objective – the developer must deliver on a fixed scope of work and the tenant will pay a pre-determined rent upon delivery. In this way, the development economics can be known before significant capital is committed. The value of the future income stream from the lease obligations can be estimated based on comparable properties and the scope of work and construction costs are largely known though subject to typical construction cost overruns (but not scope changes).

An important consequence of committing to a scope of work prior to development is that the developer must also know that the building can be constructed before the project begins. This eliminates one of the major risks in traditional development - entitlement. A thorough discussion of traditional development economics is beyond the scope of this whitepaper but traditionally a speculative developer will acquire a property based on a belief (but not certainty) that a particular project can be developed. The developer will spend much of the development cycle negotiating with the local municipality to secure a mix of development incentives and entitlements (i.e. a higher density or larger project than is contemplated under current zoning ordinances) that are subject to lengthy government and public notice processes, requiring substantial time and money to secure.

Build to Suit developments by contrast are typically built under existing zoning laws “by-right” meaning that the current municipal code allows for the construction of the building to be built and the value created by the developer comes from the pre-leasing activity rather than changes in land use. The result is a project that eliminates several years on the front end of development when significant capital would traditionally be at risk (pursuit capital) as well as one to three years of leasing and stabilization after construction. Build to Suit projects are typically both fully entitled before significant pursuit capital is deployed and also fully leased on the day the tenant accepts delivery of the property.

¹ The value in these speculative projects is created over a long period of time during which a site's allowed use is negotiated with the municipality and the public in order to develop a project that perhaps wasn't possible at the time the land was acquired. Due to the long cycle and fundamental uncertainty involved in rezoning and entitlement for such projects, securing a firm commitment from a future user is often impractical.

Build to Suit Development Process



BARRIERS TO BUILD TO SUIT DEVELOPMENTS

Pursuit Risks in Build to Suit involve less pursuit capital but are no less significant as they require significant time and expense to build the relationships necessary to secure forward commitments from tenants for specific projects – relationships that can easily sour if a developer is unable to deliver on its various promises and projections. Built to Suit developments, in many ways, can be considered a form of tenant financing. Mutual trust between tenant and landlord (borrower and lender) must be built up over time to ensure both parties are comfortable that the other party will perform on its obligations. Tenants will base future expansion, distribution, employment, and other decisions on the establishment and occupancy of the location being developed and will thereafter have a long-term commitment to use that facility. Working with an established and personally known developer/tenant relationship to ensure timely delivery of the facility according to tenant expectations is critical; even more so in the retail space as most such developments involve multiyear real estate initiatives and a series of sites and projects.

Developers in these markets typically spend eighteen to twenty-four months working with a tenant’s real estate department to establish significant relationships and understand the tenant’s objectives and needs. After the initial courtship phase, suitable locations must be identified, negotiated, and approved by both parties before third-party diligence can be conducted ¹. Only after this process has been completed and reviewed by the developer, tenant, and any construction lender would a typical Build to Suit developer acquire the land purchase and begin construction.

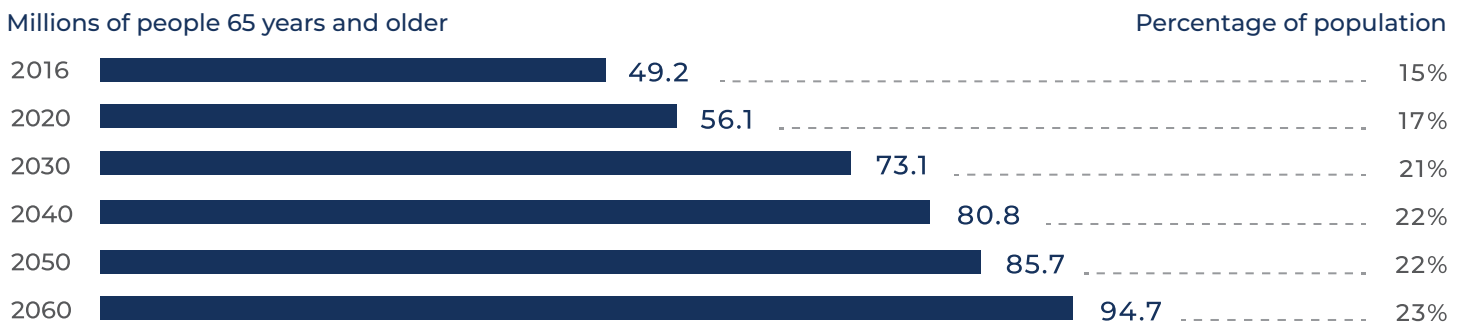
¹ Third Party reports will vary based on development and location but typically will involve significant engineering and environmental reviews.

PERIODIC MARKET DISRUPTION LEADS TO NEW BUSINESS VENTURES

Most of the time during an economic cycle, capital is plentiful for Build to Suit developments so long as the credit quality of the tenant is sufficient to support the contemplated future lease obligations. The predictable income stream and market value of the resulting net-leased asset have multiple avenues for financing and a deep potential sales pool. Over the past generation, as the population of the United States has aged, individual investors have shown steadily increasing demand for net leased real estate but even prior to this phenomenon, the predictable future income stream from the lease commitments has always attracted strong demand from institutional investors and lenders alike.

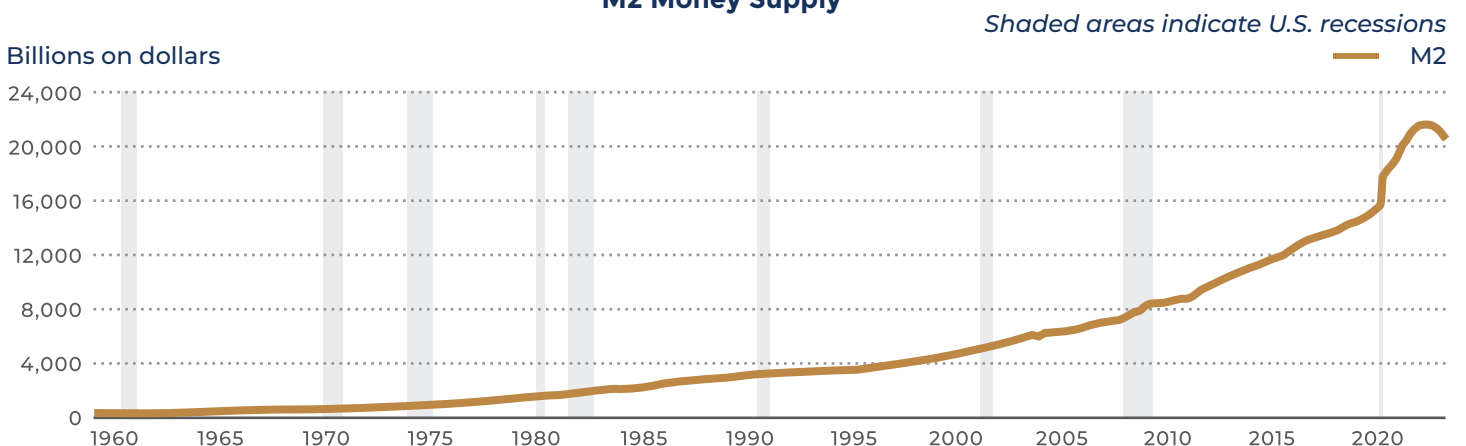
As the investor pool for these assets is typically older Americans seeking durable and predictable fixed-income investments and the percentage of Americans over 65 is projected to grow both in real terms and as a percentage of the population at least until 2060, investor demand for these assets is expected to increase over time.

Projections of Older Adult Populations: 2020 to 2060¹



Despite strong investor demand and long-term fundamental value, periodic capital market disruption allows for a reshuffling of market share amongst investors within the Build to Suit industry. As the Federal Reserve has taken steps to fight inflation - raising interest rates faster than any previous cycle and steeply reducing the money supply more than any period dating back over 70 years - the traditional sources of capital employed by many developers have been stressed.

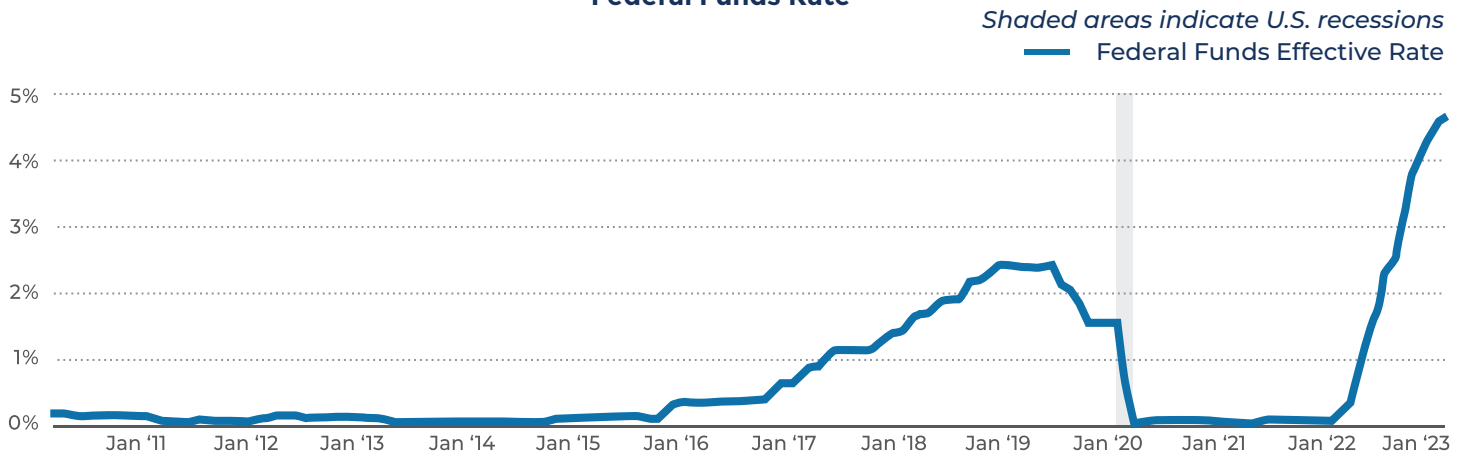
M2 Money Supply²



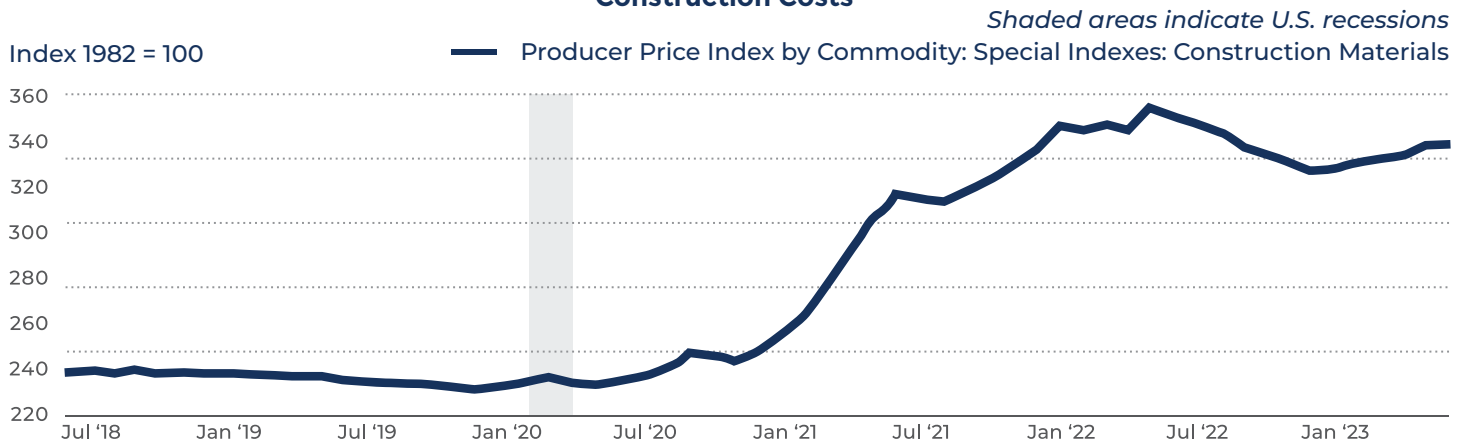
¹ Source: U.S. Census Bureau, 2017 National Population Projections

² Source: <https://fred.stlouisfed.org/series/M2SL>

Federal Funds Rate¹



Construction Costs²



Importantly this opportunity, which is created by a lack of capital available to a particular developer, can exist despite capital being readily available from capital sources that are not be part of a developer’s network. For instance, a developer that relies primarily on bank financing will not have alternate sources of capital that may still be ready, willing, and able to make such an investment, particularly if those relationships have not been previously needed and therefore largely ignored.

The aforementioned importance of mutual performance between developer and tenant requires that developers perform whenever possible on pre-existing commitments or risk losing significant future business from that tenant.

KEY RISK & OPPORTUNITY

Periods of rapid adjustment, such as has occurred over the previous three years, highlight the significant short-term market risk associated with Build to Suit developments. As discussed earlier, the capital-intensive portion of the development cycle is relatively short for Build to Suit developments. With most net-leased projects, the investment intention is to effectively mute the impact of outside market conditions – a stable, longer-term income stream can be a “set it and forget it” investment vehicle.

¹ Source: <https://fred.stlouisfed.org/graph/?g=17sOJ>

² Source: <https://fred.stlouisfed.org/graph/?g=17taZ>

However, this feature of net leased investments also magnifies market changes during the development cycle because the capital used during the development phase (debt or equity) is typically short-term and is intended to align with the relatively short construction period rather than the much longer lease term, which is the strategy traditionally employed by long-term investors of these properties. In this way, there is a timing mismatch between funding and yield that a pre-committed lease obligation cannot adjust to a rapid increase in interest rates such as has occurred since March of 2022. Developments being considered today must assume a higher interest rate in order to make economic sense resulting in a long-term higher lease rate even though the debt may be refinanced to lower rates in the future ¹.

The rapid market changes of the past three years clearly illustrate this dynamic as Build to Suit developers had a windfall year in 2021 as lease terms and contracts negotiated previously were delivered and sold into a rapidly appreciating market flush with pandemic stimulus and pent-up demand from investors. Tenants negotiated lower rents for new projects (typically as a rent factor based on development costs) to reflect this strong market. The lower development yields cost overruns, higher interest rates and the slowing market made many projects in 2022 and 2023 very difficult to deliver with any remaining profit. Projects are now being routinely renegotiated or tabled as a result.

Fortunately, the nature of Build to Suit developments typically results in a series of projects rather than an isolated opportunity. Changing market conditions can be incorporated into future projects in order to normalize the impacts of shifting market forces and ensure that the economic relationship between tenant and developer is maintained and mutually beneficial.

In other words, as development costs increase or market values adjust, the rental amounts owed by tenants under the leases will adjust for future projects to re-establish anticipated return expectations to the benefit of both parties. By establishing a pipeline of projects, rather than a single investment, the timing risks just discussed can be mitigated across multiple projects, markets, and time.

Outside of the impacts of the last several years, beginning with the COVID-19 pandemic, market conditions typically change slowly enough for this adjustment process to be fairly subdued which does not allow for the same market share disintermediation currently observed.

UNIQUENESS OF TODAY'S CONDITIONS

Every economic cycle is different, but today's stands out as particularly abnormal in the context of relative returns between debt and equity in a real estate investment. The simple concept running through how most of us evaluate investments is that priority of payment determines risk and consequently returns. Stated differently, if an investor is paid first, that investor should expect a lower potential return than an investor who is paid later. Stated still another way, all of the equity in a project is lost before the lender loses anything so it would only be natural that lenders expect to make less than equity investors but that is not the scenario we saw throughout much of 2022 as debt costs rose rapidly as a result of Federal Reserve policy ². This policy intervention is generally seen as "not market," meaning that the market believes, all else equal, rates should be lower and, therefore, investors have been slow to reprice assets, particularly long-term assets like real estate.

¹ This is only true if one presumes that interest rates will be lower in the future, which we do but is beyond the scope of this whitepaper.

² Higher priority of payment does not always result in lower returns, but the expectation of gain should be lower as the risk of capital loss is also lower.

There are studies suggesting that a similar situation occurred in the 1970s, a time similarly marked by rapid inflation and aggressive Federal Reserve tightening, but data on property values and yields should be taken with a grain of salt as the information is often self-reported and derived from multiple disparate data sources that track data differently. Although Treasuries are a different market from commercial real estate, the steepness and persistence of the US Treasury Yield curve explain some of this distortion as long-term bonds are valued significantly higher (lower yields) than short-term bonds (higher yields).

DEVELOPMENTS THAT WORK USING TODAY'S UNDERWRITING SHOULD IMPROVE OVER TIME

Investors that are paid first should expect to make less than investors that are paid later, and debt must have lower returns than equity over any sufficiently extended period of time. We believe this relationship to be fundamental, making current conditions ephemeral. Therefore, regardless of whether one believes 1) interest rates are too high or 2) property values are too high, one or both of those must be true for the natural relationship between the two to return to historic market equilibrium.

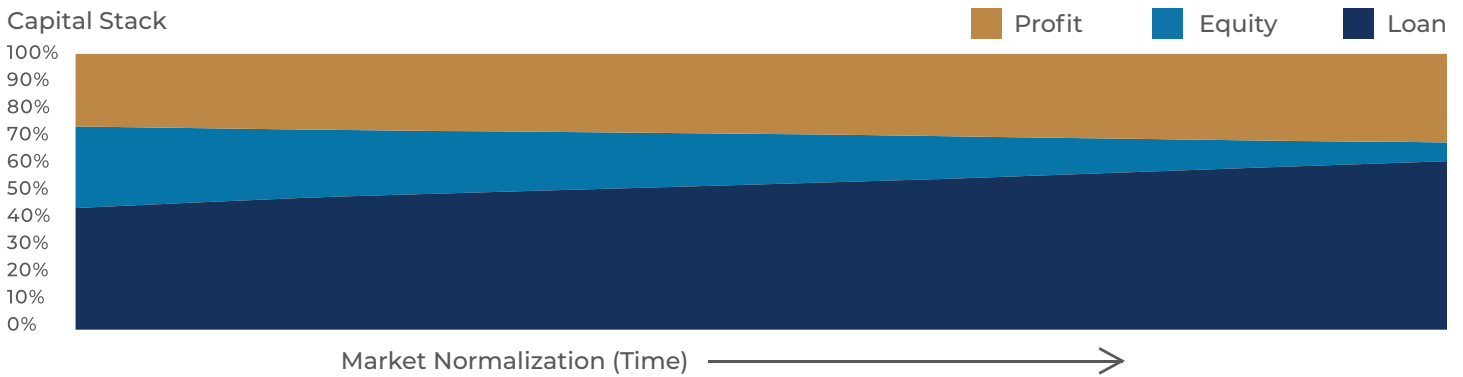
Evaluating a Build to Suit development project's economic viability requires understanding development yields and market cap rates. Cap rate refers to a capitalization rate and is most simply understood as the annual cash yield from an investment that involves no financing. For example, a 5.00% cap rate with an investment price of \$1,000,000 yields \$50,000 per year after all expenses (5.00%). It is used as a shortcut to evaluate different commercial property valuations – it is by no means a perfect valuation tool, which in truth is as much art as science despite the complicated modeling we all use to evaluate property investments. A development yield is essentially the cap rate at which a developer constructs the property – in the above example, it would cost the developer \$715,000 to deliver the property generating \$50,000 per year at a development yield of 7%. If the market conditions are unchanged between the time the development starts and the time the property is sold, this development spread of 2.00% or 200 basis points would yield a profit of \$285,000 on a \$715,000 investment (which itself could be largely financed) leading to a very profitable development considering that most of the variables were controlled throughout the entire cycle.

We use a 200-basis point development spread in many of our examples because that is a fairly typical target for such developments even though in practice, stronger developments, tighter markets, and higher-quality tenants are often able to negotiate for lower development spreads. Lower development spreads lower the cost of the lease to the tenant such that a sophisticated and creditworthy tenant will always work to push for such lower development spreads and consequently lower rents (or higher quality real estate).

Keeping a presumptive 200 basis point spread of market cap rates (sales value) versus development yield (development cost basis) we find that today's projects are likely at a short-term trough for profits such that a development pipeline is reasonably predicted to expand profitability over the recovery in the economic cycle. This analysis requires several assumptions but applies equally whether we assume interest rates will fall or cap rates will rise in the future. As we established earlier, each project carries market adjustment risk, so in the case of rising cap rates, current projects will suffer, but the long-term gains from higher cap rates (as future development projects are underwritten with higher development yields) make up for this short-term degradation in profits – analogous to dollar cost averaging when investing in stocks. The key to either scenario is the normalization of the market relationship between debt and equity. In the scenario where interest rates fall, the cost of debt primarily drives higher profits as the economic incentive reverts from lender to equity.

In the case of the higher persistent financing costs and a corresponding rise in cap rates, the increased profits derive primarily from the greater amount of overall return generated by the project (reflected by higher yields overall). Either adjustment is positive for the investment cycle.

Expanding Profit Potential of Build to Suit Developments¹



THERE IS REASON TO BELIEVE THAT TODAY’S DEVELOPMENT ASSUMPTIONS ARE OVERLY PESSIMISTIC

Projects underwritten today typically have healthy cost contingencies included in their budgets due to the rapid recent (but abating) construction cost increases that were the hallmark of the post-pandemic environment. While waiting for interest rates to fall has proven a poor strategy for much of the past 18 months, construction materials and labor costs have started to moderate and decline as demand softens and supply chains correct ².

Interest rates continuing to increase, driving cap rates higher will lower development profits for current projects whereas falling interest rates and the market normalizing at lower cap rates would expand the profit margins of those projects – a dynamic that appears weighted to the latter scenario given that the market anticipates the Federal Reserve is at or very near the end of its tightening cycle ³.

CONCLUSIONS

- ✔ Build to Suit developments provide attractive risk-adjusted returns with high barriers to entry because of the established relationships necessary to secure development opportunity pipelines of any scale.
- ✔ Performance and reliability are key factors in the success of any long-term development relationship, with current market factors forcing market participants to seek new relationships that will be mutually beneficial throughout the next business cycle.
- ✔ Strong (conservative) underwriting for today’s projects and pipelines will likely set up even more attractive returns in the coming years.

¹ As the relationship between development yields and financing costs normalize, profitability expands on both a percentage and real dollar basis.
² Source: <https://fred.stlouisfed.org/series/WPUSI012011#>
³ Source: <https://www.reuters.com/markets/rates-bonds/fed-is-close-end-rate-hiking-cycle-central-bank-officials-say-2023-07-10/>

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