

Real problems

Lessons learned from the real estate industry **Interviewed by Matt McClellan**

Having a finite resource as your business's main asset has proved challenging for real estate companies, but it has necessitated some creative problem solving.

For years, the real estate industry reaped the benefits of constant appreciation. Unfortunately, no one is manufacturing more land, and most real estate isn't worth what it used to be.

"Although we've gone through recessions, you would probably have to go back to The Great Depression to find a period of time when real estate has suffered such a sustained depreciation in value," says Robert A. Ranallo, CPA/ABV, JD, CVA, CFF, a partner with Skoda Minotti.

"Now, real estate companies can only generate profits from operations. Before they generated profits from operations and the appreciation of the land they were holding or selling."

Smart Business spoke with Ranallo about what businesses can learn from the real estate industry's recent hurdles.

What challenges does the real estate industry face today?

There are two main sectors of the industry: commercial and residential. Commercial can be anything from large multi-family developments to commercial retail centers to industrial buildings to office buildings. Residential is typically characterized as developers who buy and develop land and resell lots for the construction of single-family homes or housing developments.

Each of those two areas has its own unique challenges. However, there are two primary challenges that have adversely affected both sectors over the past year and a half: the absence of credit and the economic loss in value of the underlying real properties in question.

How have these issues affected those in the industry?

The reality is that real property is not as valuable as it was a few years ago. The decrease in property values just exacerbates the credit problem, because what once were acceptable loan-to-value ratios no longer exist after a readjustment in value. It's not uncommon for loan values to now be greater than the underlying value of the real property itself.

What causes this to come to the forefront is that many banks are having trouble maintaining required capital levels. Developers often



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are not able to meet debt service requirements. Properties are being re-underwritten, but the underwriting standards that are being applied leave the developers in a position where they oftentimes do not have the cash or financial wherewithal to comply.

For many years, the real estate industry benefited from the fact that real property continually appreciated in value. So when a loan was made on a project, the underlying values of the property would typically appreciate and the loan-to-value ratio would get smaller, which is good for the bank because there is more equity in the project. Over the last two years, however, that trend has reversed dramatically. When you couple that phenomenon with the squeeze the banks find themselves in on their capital requirements and the absence of credit, you have a toxic mix.

How are real estate companies adapting to this situation?

They are trying to survive. On the residential side, foreclosures are at an all-time high and credit is tight. Would you go into a business where you build a new house on speculation and hope to find a buyer for it, then hope that buyer can find financing to purchase the house? People became much more conservative because their incomes

have been cut and their job situation has become more uncertain. Thus, the universe of prospective buyers out there has shrunk significantly.

It's not much better for commercial developers. Retail has become so fragile that anchor tenants of a shopping center could file bankruptcy and go out of business at a moment's notice. So where does that leave the developer who was counting on that rent to pay his debt service?

That's another hazard that the real estate industry faces, particularly on the commercial end.

Apart from the real estate industry having its own challenges, who pays the rent and what impact does the economy have on those who are paying the rent? It's a ripple effect. If you look at the larger developers of retail properties, the name of the game is to pay down debt and hoard your cash.

What must be done to survive?

Taking steps to try to preserve revenue to the greatest extent possible, while enhancing revenue wherever possible. Also, manage operations more efficiently. That means cutting expenses, because profit margins are down. Many developers don't have a positive profit margin anymore. The endgame is making sure you have enough revenue to survive.

For the small developer, it could mean selling lots for no profit; it could mean selling lots at a loss just to get out from underlying debt service.

For commercial developers, it could mean putting tenants into space at less than market rates. The irony there is no one knows what market rates are anymore because the economy is in such a fluid state right now. You have to ask yourself: Am I better off with 100,000 square feet of empty space, or am I better off with 100,000 square feet of space leased at half of what I think market price is?

What lessons can other industries learn from the challenges the real estate industry faces?

Borrow prudently. Don't overleverage. Make sure you have money for a rainy day — a rainy day could last a long time. Many problems the real estate industry faces now are a result of overleveraging. When that overleveraging is coupled with depreciation in underlying value, that's not a good combination. <<

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