Real Estate Development Dynamics

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- **Who Am I?**

- **Real Estate Development Dynamics**

Who Am I?

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Work History

- 4 years working as an investment banking analyst in the real estate sector
- 9 years developing retail, office, and senior housing projects in Florida
- 13 years advising and teaching students at UNC Kenan-Flagler Business School
    - 2 years advising MBA real estate and investment banking students and employers
    - 10 years running the Wood Center for Real Estate Studies
    - 4 years teaching MBA and undergraduate real estate courses, including capstone development course to 2nd year MBAs

Academic History

- MBA from University of Florida
- BSBA in Finance from University of Florida
- BA in Political Science from University of Florida

Personal

- Chapel Hill resident since 2011
- Wife teaches in CHCCS system
- Son at UNC-Chapel Hill and daughter at East

Why does development occur?

- **Control land (site looking for a use)** – example is University Place

- **Control knowledge or tenants (use looking for a site)** – example is The Hartley at Blue Hill

Why does a developer do?

Orchestrates a creative process to generate economic value by answering four main questions:

- **What can be built?**
- **What cash flow stream will it create?**
- **How much will it cost?**
- **How will I pay for it?**

What are the phases of the development process?

- **Pre-Development** – Developer identifies land, has idea, lays out development plan and pursues entitlements and approvals. (This is the riskiest part of the process for the developer.)

- **Development** – Developer achieves land control, capital (debt and equity), executes construction and lease-up to stabilization.

- **Stabilized Operations** – Developer turns over to property management and decides on future sale or long- term financing.

What are the phases of the development process?

Pre-Development

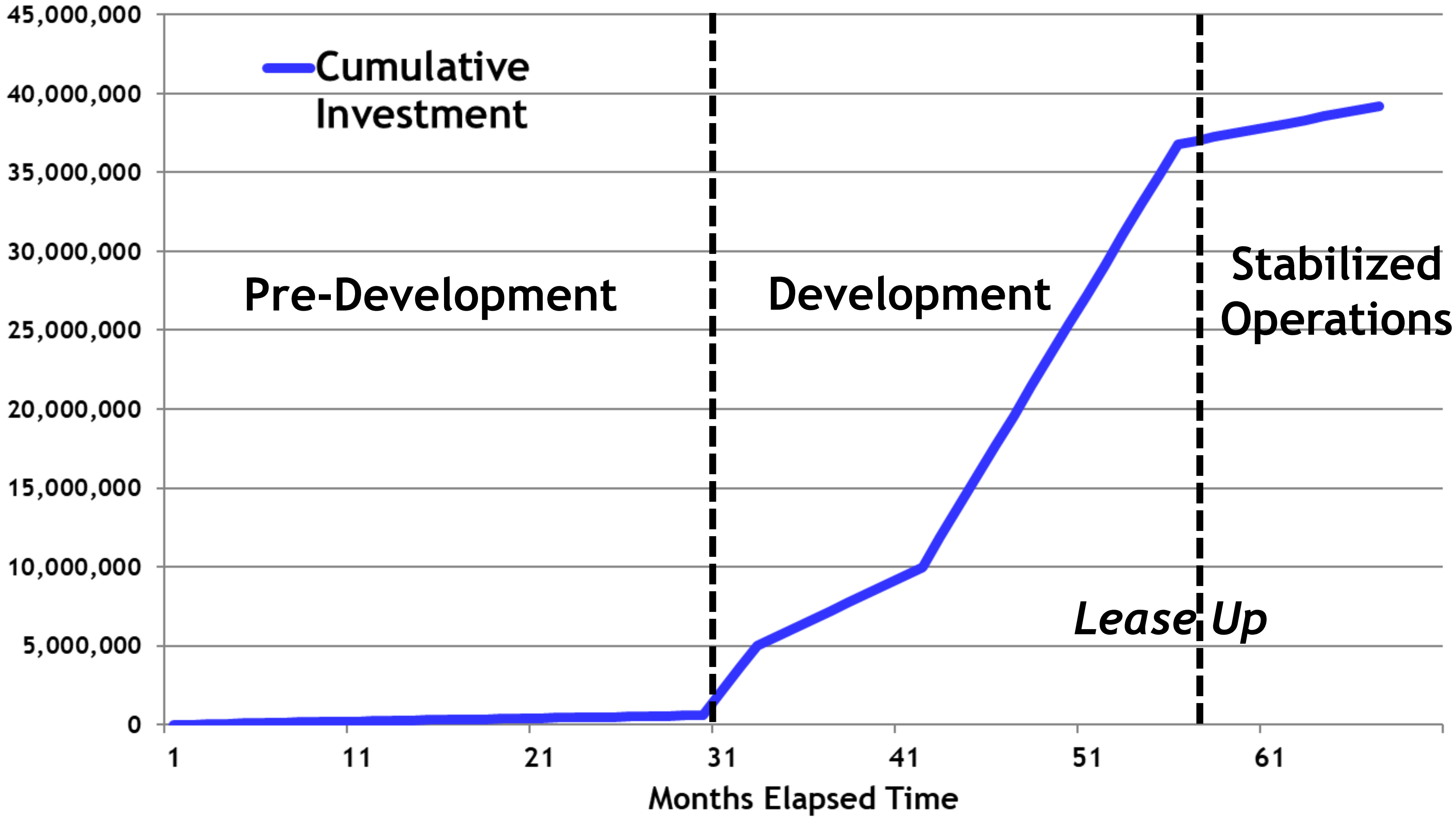
- Idea Inception
- Idea Refinement
- Feasibility Study
- Contract Negotiation

Development

- Formal Commitment (Land Closing)
- Construction
- Completion and Formal Opening (Lease Up)

Stabilized Operations

- Property Management
- Asset Management
- Portfolio Management



What are the primary cost components?

- **Hard costs (construction)** – generally 60-80% of total cost
- **Land** – generally 10-30% of total cost
- **Soft costs** – generally 10-20% of total cost

Interest Expense	Real Estate Taxes
Operating Deficit	Insurance
Title Insurance, Recording & Closing	Financing Fees
Due Diligence	Marketing & Leasing
Legal	Development Fees
Architecture & Engineering	Entitlements, Permits & Impact Fees
Contingency	

How are developers compensated?

Value Creation

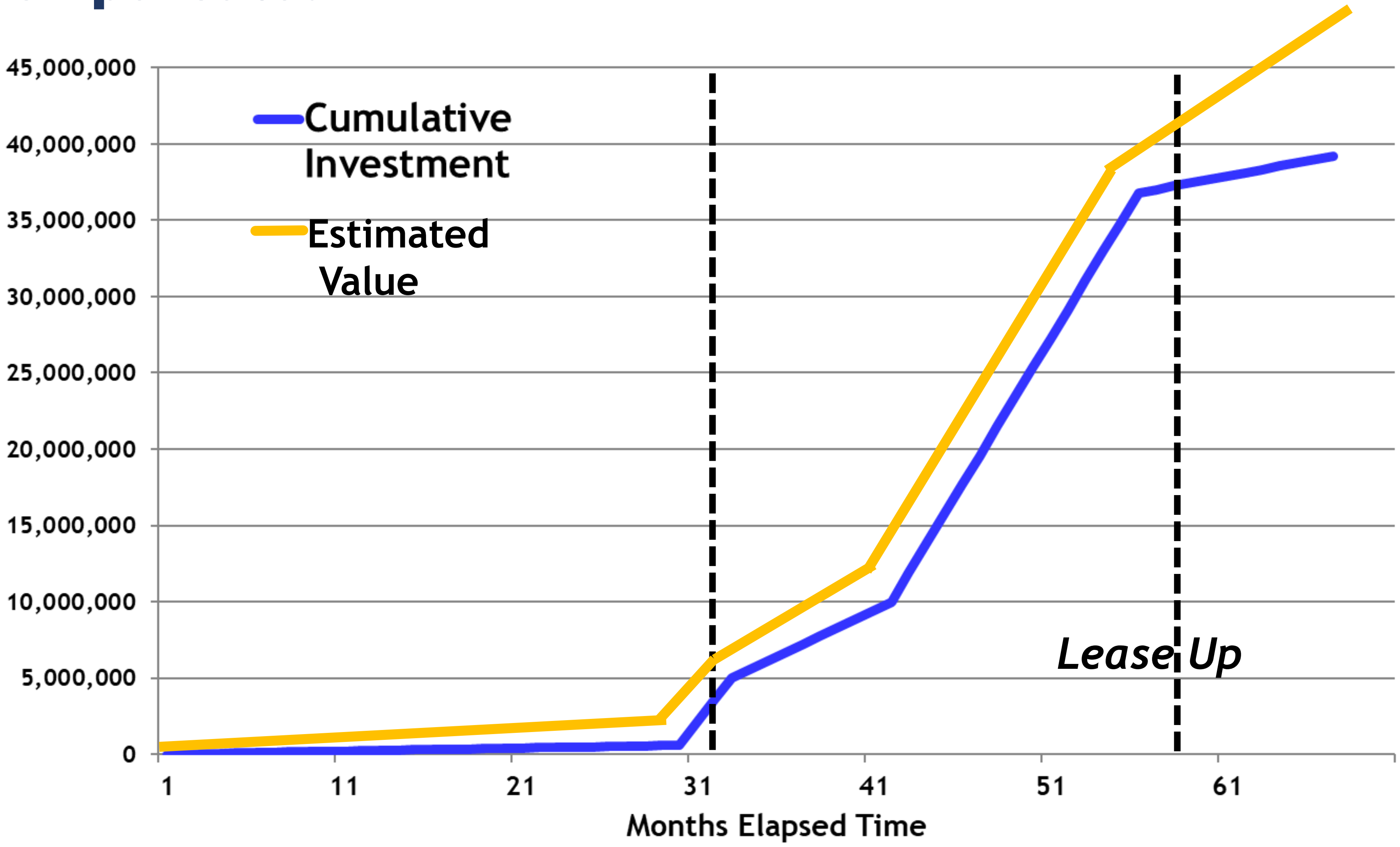
Positive difference between cost and stabilized value – biggest return component

Promote (Carried Interest)

Outsized capture of project cash flows – usually appears near end of deal – compensates for work and risk

Development Fees

Typically % of costs paid over project – keeps the lights on



Given limited time and resources, how do developers assess a deal?

- Is the project profitable?
- What are the major risks?
- Does the spread between the stabilized project value and current market values adequately compensate the developer for the risks?

Is the project profitable?

Rental Product

Stabilized Rents *(Market Driven)*

Minus Stabilized Expenses

Equals Stabilized Net Operating Income

Divided by Market Cap Rate

Equals Stabilized Project Value

Less Total Development Costs

Equals Profit

For-Sale Product

Gross Sales Proceeds *(Market Driven)*

Minus Sales Costs

Equals Net Sales Proceeds

Less Total Development Costs

Equals Profit

What are the major risks?

Market Risk

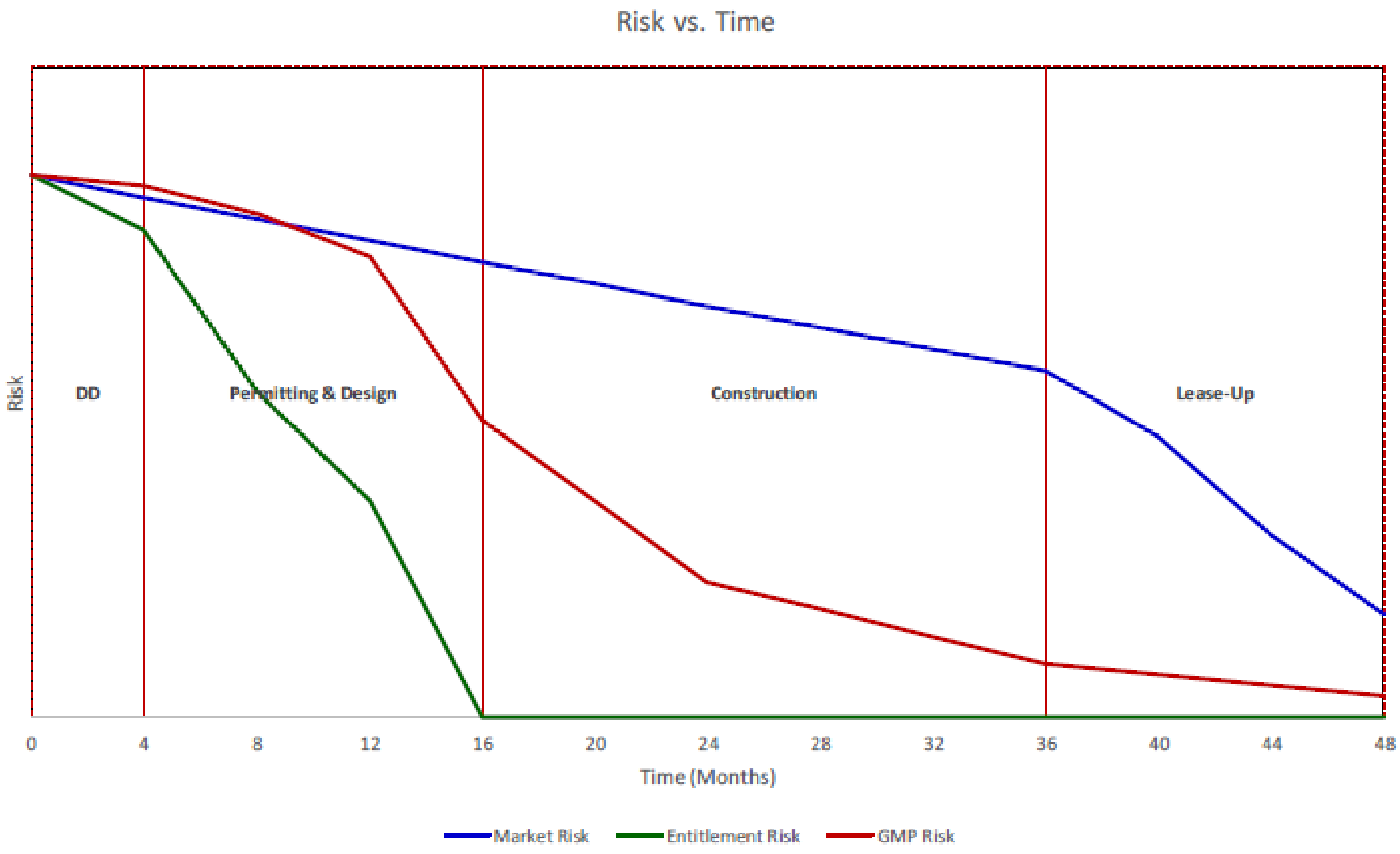
Supply and demand (dictates rents and lease-up or sales prices and velocity) as well as capital availability (debt and equity)

Entitlement Risk

Zoning/entitlements (legally feasible), site yield (physically feasible)

Construction (GMP) Risk

Horizontal and vertical construction cost



Does the spread between the stabilized project value and current market values adequately compensate the developer for the risks?

Multifamily For-Rent Product Example

Stabilized Rents	$5,000,000	*Subject to market risk*
Stabilized Expenses	($2,000,000)	*Subject to market risk*
Stabilized Net Operating Income (NOI)	$3,000,000	
Total Development Costs (TDC)	$40,000,000	7.5% Development Yield (NOI/TDC)
Stabilized Project Value (NOI/MCR)	$50,000,000	6.0% Market Cap Rate (MCR)
Projected Profit	$10,000,000	1.5% Development Spread

Does the spread between the stabilized project value and current market values adequately compensate the developer for the risks?

Townhouse For-Sale Example

Gross Sales Proceeds	**$20,000,000**	***Subject to market risk***
Sales Costs	**($1,200,000)**	
Net Sales Proceeds (NOI)	**$18,800,000**	
Total Development Costs (TDC)	**$15,000,000**	
Projected Profit	**$3,800,000**	**25.3% Profit Margin**

What is shaping the current real estate development landscape?

- **Population and demographic shifts** – Continued steady movement of people from Northeast/Midwest to South/West resulting in strong population and income growth in markets like the Triangle.
- **Construction cost increases** – Combination of supply chain disruptions and persistent labor shortages putting upward pressure on construction costs.
- **Interest rate increases** – Strong upward movement of both short-term and long-term interest rates leading to increased soft costs for developers as well as lower stabilized project values.
- **Insurance cost increases** – Rapid escalation of property insurance costs eroding net operating income for for-rent projects.
- **Elevated multifamily deliveries** – Record number of for-rent multifamily project deliveries in 2024 and 2025 in high-growth markets like the Triangle putting downward pressure on multifamily market rents and, consequently, stabilized project values.

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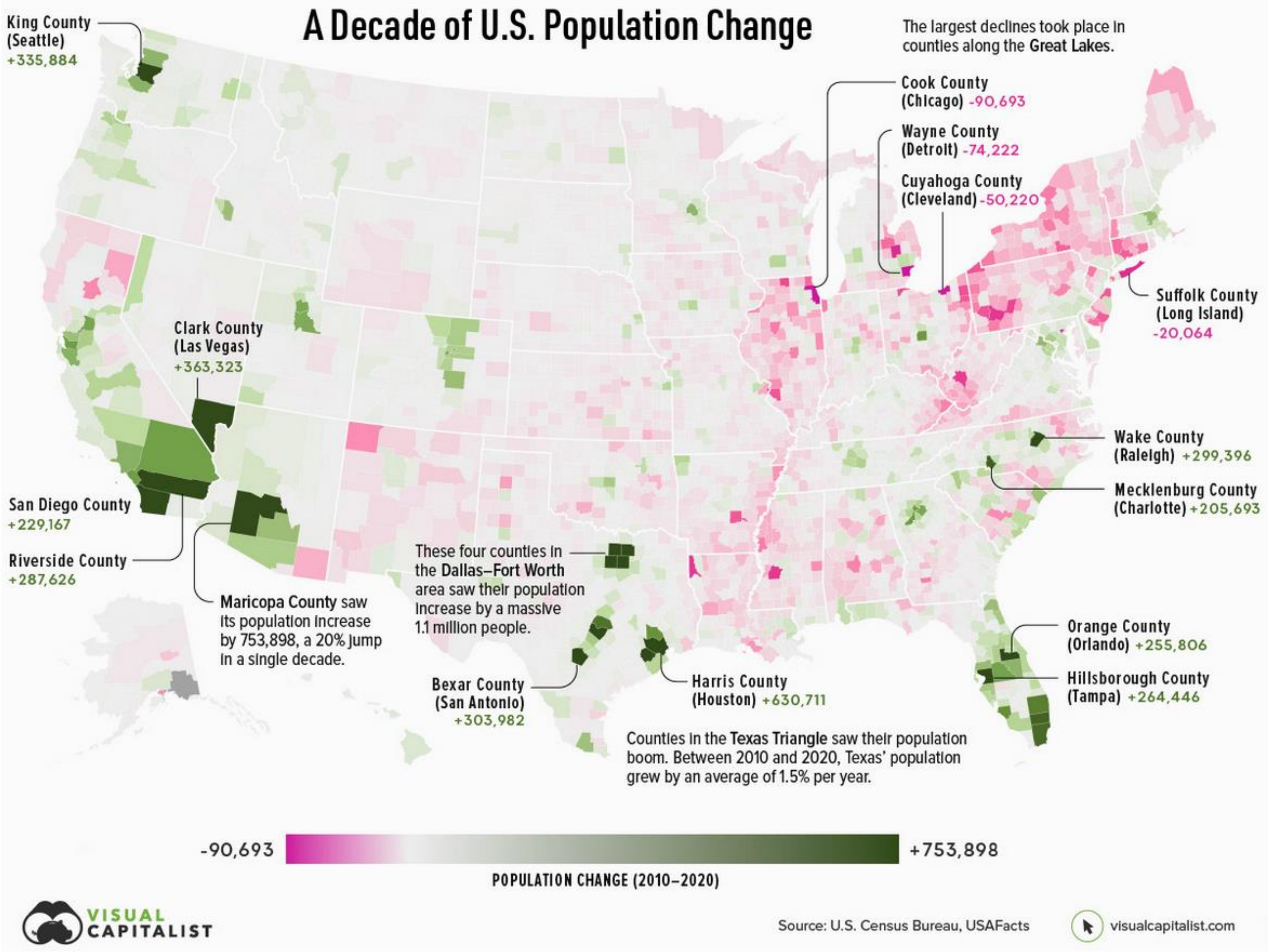
Population and demographic shifts



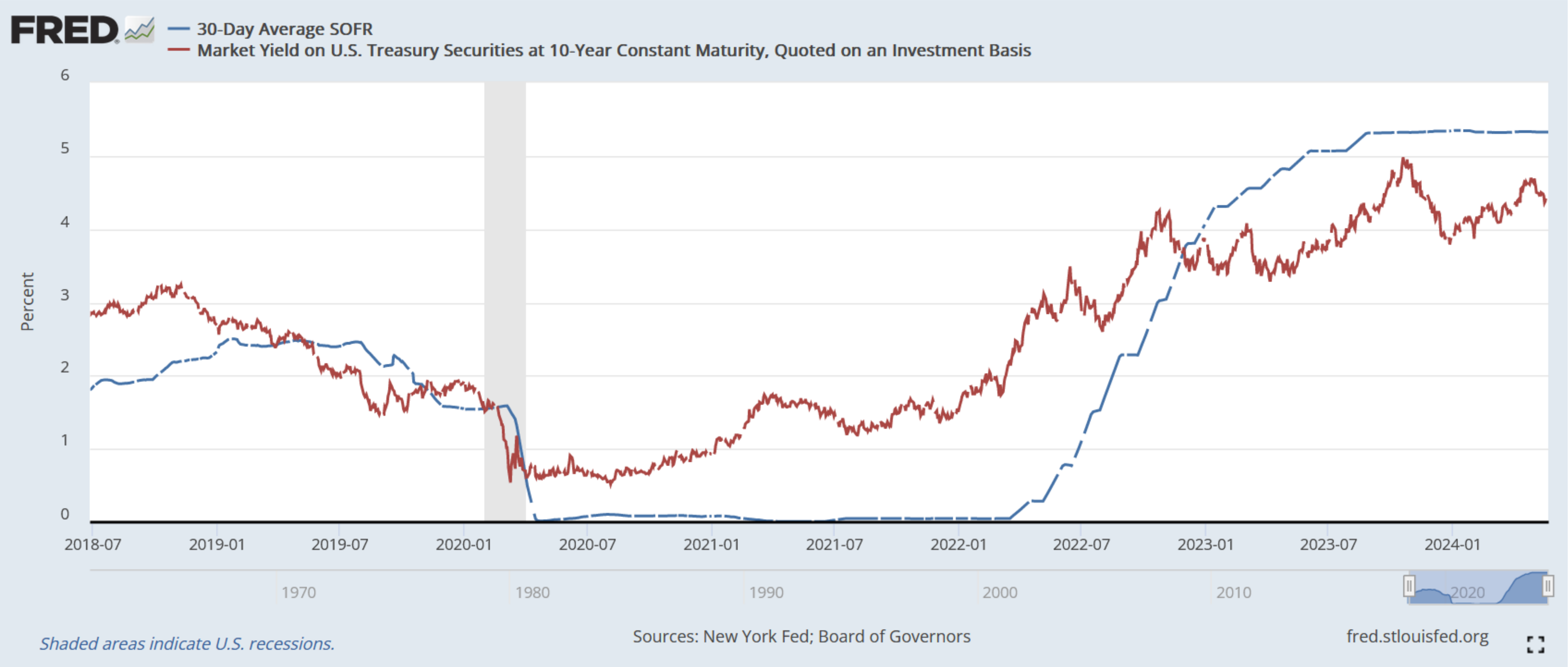
Construction cost increases

Producer Price Index, June 2023

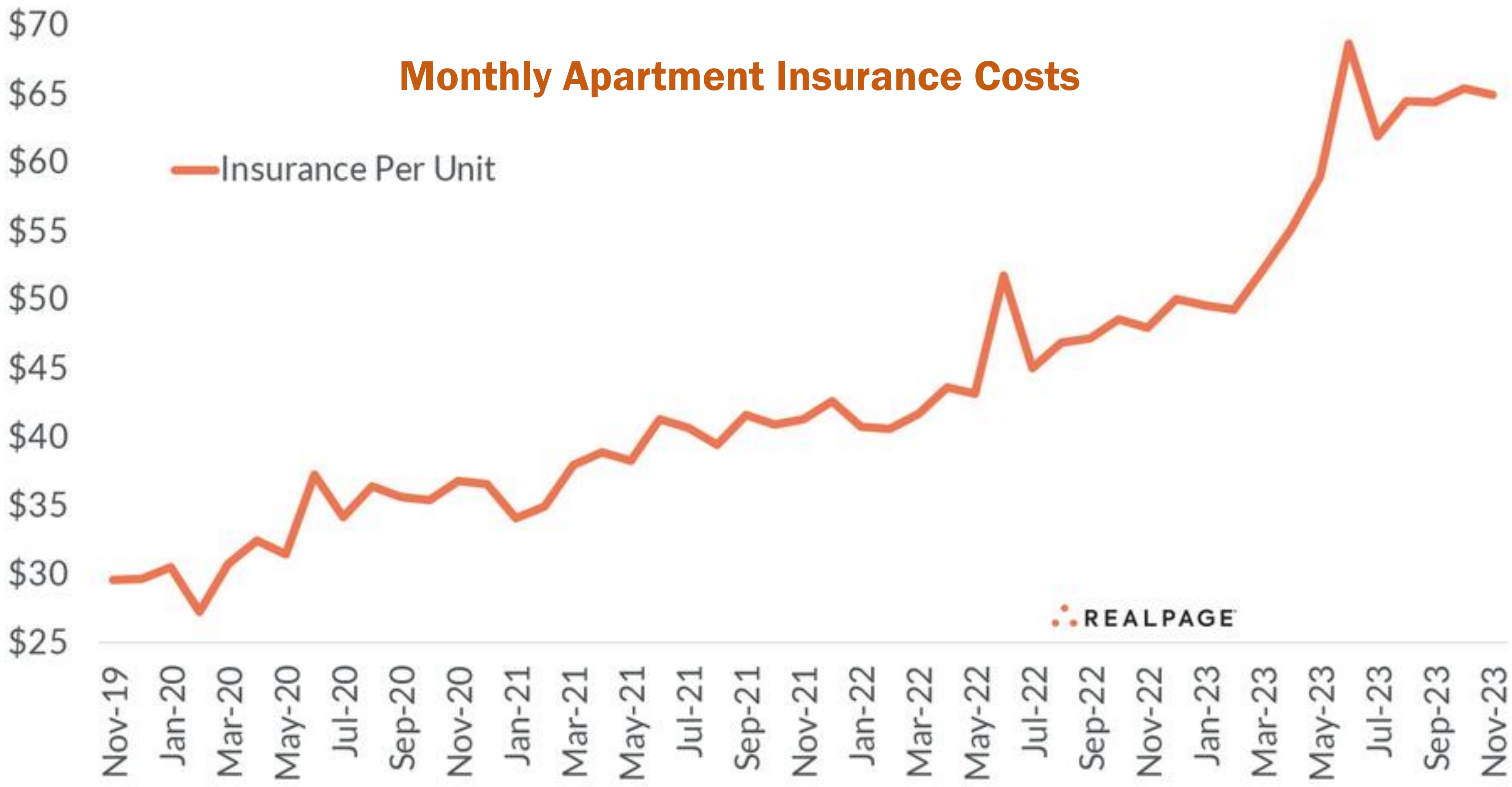
	1-Month % Change	12-Month % Change	Change Since Feb 2020
Inputs to Industries			
Inputs to Construction	0.0%	-4.9%	38.3%
Inputs to Multifamily Construction	0.1%	-2.0%	37.1%
Inputs to Nonresidential Construction	0.0%	-4.5%	39.2%
Inputs to Commercial Construction	0.1%	-2.5%	39.7%
Inputs to Healthcare Construction	0.0%	-2.4%	39.1%
Inputs to Industrial Construction	0.1%	-2.0%	34.7%
Inputs to Other Nonresidential Construction	0.0%	-5.2%	39.0%
Inputs to Maintenance and Repair Construction	-0.1%	-5.8%	36.5%

Source: U..S. Bureau of Labor Statistics

Interest rate increases

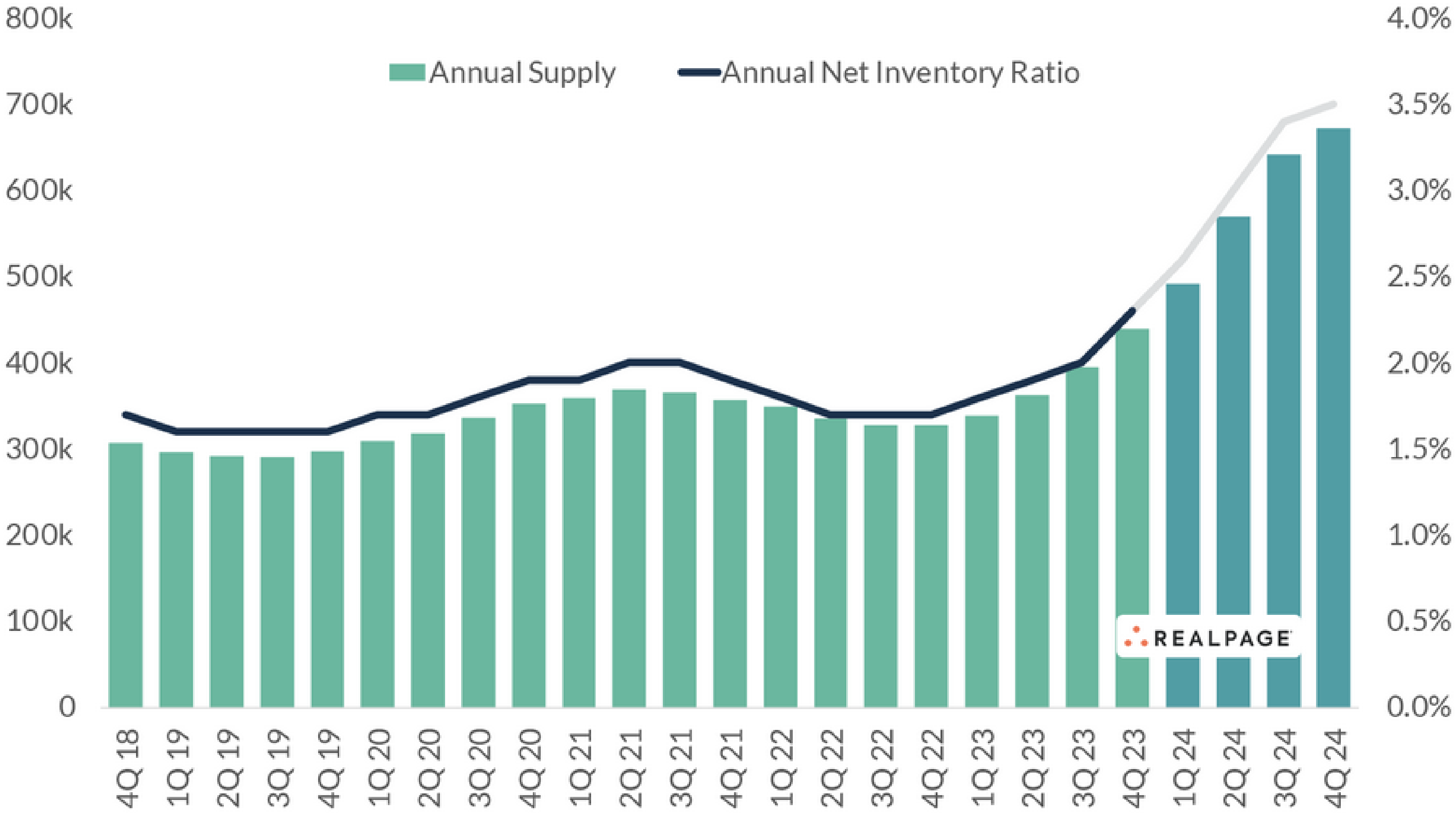


Insurance cost increases



Source: RealPage Market Analytics

Elevated multifamily deliveries



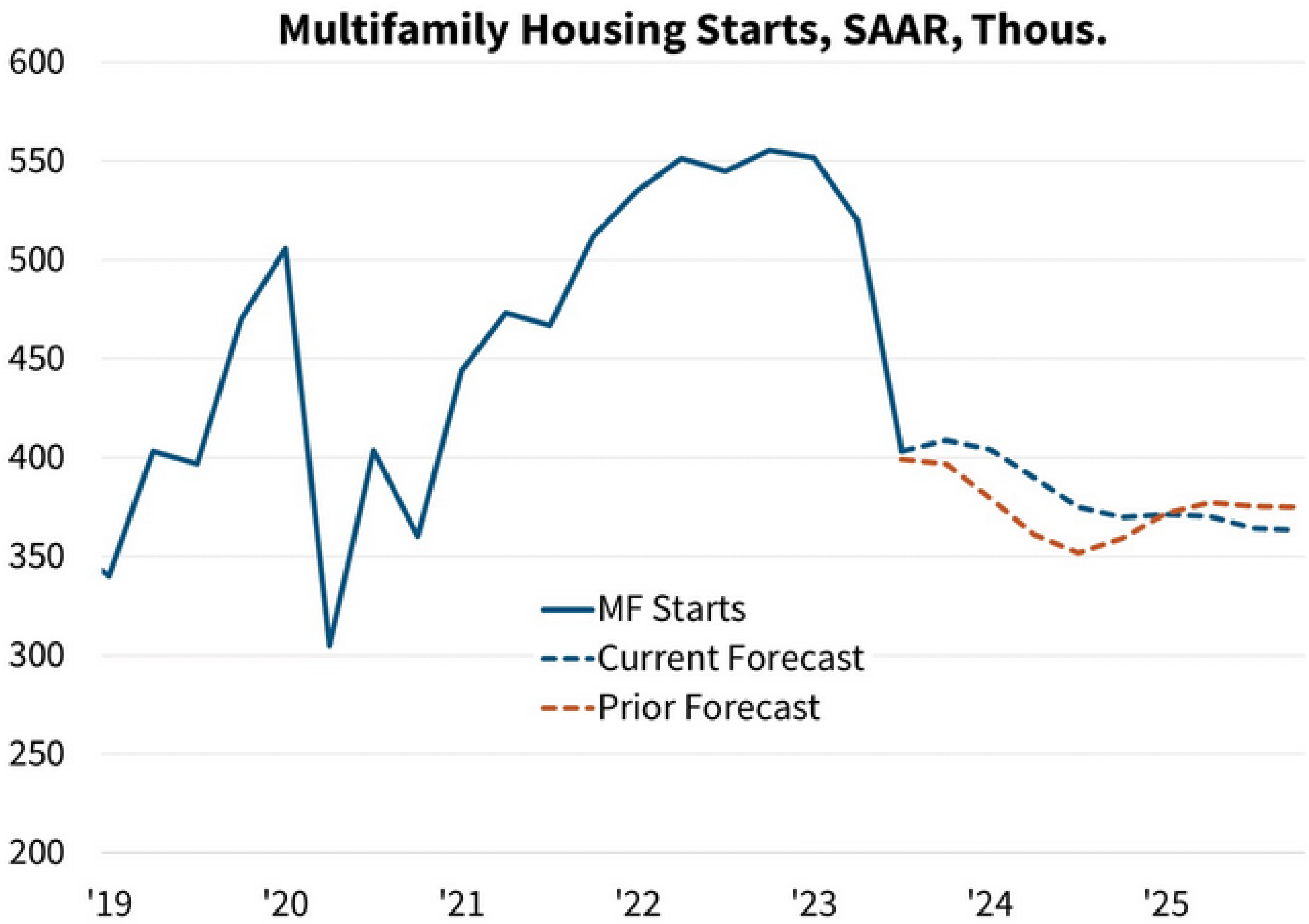
Source: RealPage Market Analytics

How do these factors affect the developer's decision?

Multifamily For-Rent Product Example

Stabilized Rents	**$4,500,000**	***5% rent reduction***
Stabilized Expenses	**($2,200,000)**	***50% insurance expense increase***
Stabilized Net Operating Income (NOI)	**$2,300,000**	
Total Development Costs (TDC)	**$46,000,000**	***20% construction cost increase***
Stabilized Project Value (NOI/MCR)	**$32,900,000**	***7.0% MCR (100 bps increase)***
Projected Loss	**($13,100,000)**	**-2.0% Development Spread**

New multifamily starts



Source: Fannie Mae

What are the key takeaways?

- **Development is feasible when a project's expected market value/net sales proceeds exceeds its total development costs** – developers must account for market risk, entitlement risk, and construction risk in evaluating this equation so crave certainly in execution and timing

- **Developers are primarily compensated via the spread between expected market value/net sales proceeds and total development costs** – consequently developers are incentivized to maximize value and minimize costs during the development process

- **During pre-development, developers must constantly assess due diligence and entitlement expenditures against projected development spread (profit)**

- **Current development activity is muted due to a variety of market factors** – despite population and demographic tailwinds in the Triangle, new development will be limited in the near-term until some combination of construction cost decreases, interest rate decreases, market cap rate decreases, and new supply absorption (with respect to for-rent multifamily) takes place

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