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Skin in the game: What will happen to the future of the commercial development market?

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The recent subprime crisis has left anyone involved in real estate biting their nails and wondering what will happen next. What many might see as a time of crisis, others see as simply a change in the tides of the market.

Right now, one of the biggest concerns is the immediate and future effects that the credit crisis will have on the commercial real estate market.

The commercial real estate market and more specifically the commercial development market, which is one of New York City's biggest industries, have definitely felt the effects of the subprime crisis. And although the development industry in New York City may be feeling the effects for the next few months, this is not the end of a relatively aggressive development market.

What is the most immediate effect? In a nut shell, a tighter lending market on all fronts.

Although it may seem that the changes to the commercial lending and effectively the commercial development market have only come over the last month, in actuality things in the marketplace have been changing slowly and consistently for the past year. There have been two general trends: the fluctuation of interest rates and the tightening of lending criteria.

In truth, the increase and/or decrease in interest rates is largely dependent on the Federal Reserve. It is the resulting instability of the interest rates that has made it increasingly difficult for lenders to quote and hold interest rates for borrowers. On this front, our crystal ball is no better than anyone else's.

The tightening of lending criteria has manifested itself in a greater demand by lenders for more borrower equity in transactions. This increase in demand can be seen in a couple of recent trends. First, there is a greater reluctance to permit mezzanine borrowing, which effectively reduces a developer's equity investment in their projects. Secondly, there has been an insistence on higher debt service ratio and a greater emphasis in development deals on the quality of the tenants' credit. Essentially, lenders are asking that the borrowers have more "skin in the game".

Several lenders in our practice have suggested that their developer/borrower lay low for the next month or two

– the idea being that what goes up must eventually come back down and the credit crunch will eventually reverse itself.

Some of our developer clients have simply renegotiated with their lenders and accepted higher debt service ratios or greater equity requirements.

There are also those developers who already have enough “skin in the game”. These are the developers that have enough equity in their projects and can afford to either wait out the market or close in the face of the market.

So then the question becomes what will happen to the future of the commercial development market and how do we prepare ourselves. As we have seen over the past couple of months, because it is so hard to predict the future of this market, many people think that simply waiting to see what will happen is the best option. But with a good deal, a good team and enough equity in a project, we have seen deals being done and options being available to developers. In the end although the commercial development market will likely slow down, it will not come to a stand still.