

New Ground-Up Developments Are Unprofitable under current conditions.

“At current cap rates, retail market rents need to rise 30% to 50% above their current levels before new construction projects can generate reasonable risk-adjusted profits.”

Successful real estate investing requires superior local market knowledge and proper risk assessment and thoughtful cost and profit projections based on historical project and development costs and market rents.

It is surprising to see how few real estate development companies have actually invested the time and effort to collect data and study their local markets. Unfortunately, the existing online data services currently do not have complete statistics for Florida, and therefore there is no shortcut to Woolbright's approach of regularly visiting every retail property in the major metro areas of Florida.

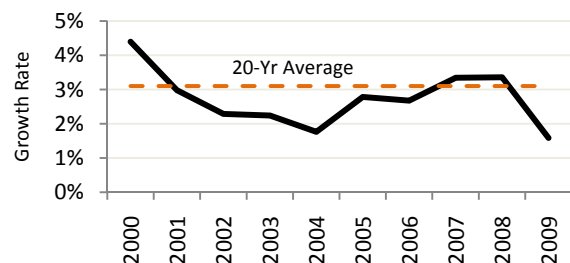
Many people have asked recently about undertaking new ground up developments as land prices and construction costs have fallen. However, under current conditions, new ground-up retail developments do not make any economic sense: rising capitalization rates and falling rents make it impossible to generate a profit.

While construction costs have fallen in recent months in response to the precipitous drop off that we have seen in the number of new construction projects that have been commenced, there is a limit to how much farther those costs can fall. The last eight ground-up projects constructed by Woolbright

came in at \$250-\$350 per SF of project GLA, excluding the cost of the land. These costs included everything, even corporate overhead. Many developers do not really appreciate the actual “all in” cost of developing a ground-up shopping center project.

Nevertheless, let's be very optimistic and suppose that a new development could be completed for just \$200 per SF of project GLA, excluding the cost of the land. This figure is 20% to 30% lower than the actual costs incurred by Woolbright in connection with its recent projects, and as sum, is probably an unachievable level of savings. However, we can use this per-square-foot figure to consider the feasibility of new projects under falling construction cost assumptions.

**Historical Retail Construction Growth Rate
South Florida**



Retail ground up construction will fall to its lowest level in history in 2009 and continue declining to just 1% growth in 2010 and 2011.

The second factor to be taken into account is the cap rate for the project. As a result of the credit crisis, cap rates for new retail projects are now in the 8% to 9% range in Florida's major metropolitan markets. A prudent developer should endeavor to achieve a sale price for his completed project that is not less than 130% of his total project cost. So, to achieve that objective, at current capitalization rates, a developer's return on cost must be 10.5% to 12.0%, which is an increase of 130% above the capitalization rate for a sale. The exact “return on cost” value is completely dependent upon the location and anchor tenant.

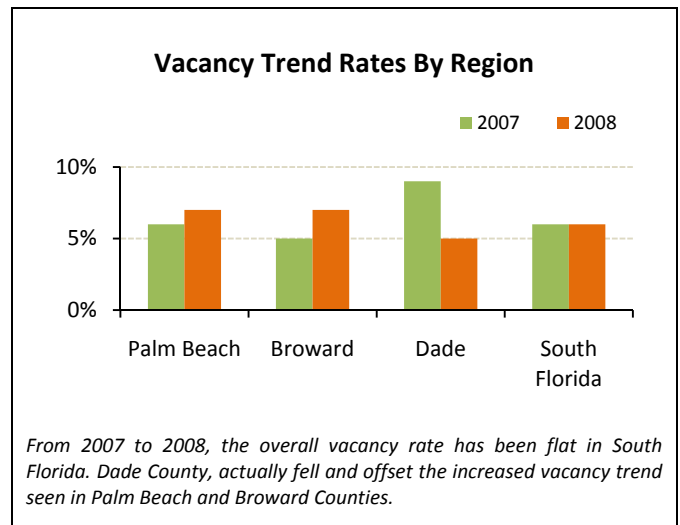
Now let's consider a sample project and we will assume that an 11% "return on cost" is a good midpoint figure on which to evaluate the deal.

If the developer's purchase price for the land equates to \$100 per SF of proposed GLA, and if the developer's all-in costs for the project totals an additional \$200 per SF of GLA, i.e., in addition to the land cost, then the developer's total project cost will be \$300 per SF of GLA. To make a good profit, he will need project rentals that average \$33 per SF which represents 11% of the total cost of \$300 per SF.

If the anchors lease half the space in the project and pay rent at a per-square-foot rental rate that is about 50% of the average per-square-foot rental rate payable by the local tenants, then in order to achieve the desired return, the anchors would have to pay rent at the average rate of \$22/SF and the locals would have to pay rent at the average rate of \$44/SF. Those rental figures are 30-50% above the current market rents. Accordingly, under current conditions, it is simply not possible to get a center filled at such high rents and consequently, it is simply not possible for the project to be profitable. Indeed, it is not likely that the project will be able to command rental rates at those levels for between 5 and 7 years. What should happen in the meantime? Developers must simply stop building new projects until tenants are willing to pay rents high enough to support a profitable project.

Over the last 8 years there was a balanced level of development supply introduced to the market and by historical standards, there is currently a relatively low-level of vacant retail space. Eventually, as the economy improves, the vacant space in the existing centers will fill up and rents will begin to rise again. For now, it's a tenant's market. Yet, in about 5-7 years, the anchor tenants will be in such desperate need of new locations, that they will be forced to

pay the higher rents needed to support new store construction.



At that point, new construction will begin again. In the meantime, the best place to invest is in existing centers. Existing shopping centers will be trading in the \$100-\$200 per SF range over the next few years. Those price levels are about 1/3 to 1/2 of the cost to build a new project. This gives buyers of existing properties a big advantage over developers of new projects because they can offer significantly lower rents and still make a profit.

New development projects which have not yet begun should be postponed until market conditions improve. It is far better to do nothing than to begin an unprofitable venture. The invisible hand that organizes the economy will straighten out all of the excesses and until then, patience is the order of the day.

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About Woolbright Development

Woolbright Development is one of Florida's largest private owner/developers of retail shopping centers based in Boca Raton, Florida. Further information on the firm along with a complete listing of our portfolio can be found on our website www.woolbright.net. For more information about Woolbright's research please email to lhoyer@woolbright.net or call Liz Hoyer, Research Director 561-989-2247.