

COMMERCIAL REAL ESTATE

Spurned by Banks, Builders Look Elsewhere

Private Equity Steps Up to Fund Smaller Developers as Traditional Lenders Balk—but the Cash Doesn't Come Cheap

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LAS VEGAS—Private-equity firms are stepping into the vacuum left by banks' flight from lending to small and midsize home builders.

"The banks just are not doing construction loans," says Robert Mecay, a real-estate developer who is trying to build a luxury condominium complex on the south shore of Lake Tahoe in Zephyr Cove, Nev. So Mr. Mecay and his partners in the Tahoe Beach Club project are seeking \$150 million of equity or debt financing from private-equity firms.

The money isn't cheap. For loans, some private-equity firms were offering interest rates of roughly 15% to 20%. But Mr. Mecay, whose previous projects have relied on bank loans, wants to start the project soon, while construction costs are low as subcontractors and suppliers scrap for scarce business.

"We need to get moving," Mr. Mecay says. Developer's Financial Solutions Inc., a financial-advisory firm in Rancho Santa Fe, Calif., is trying to line up financing for Mr. Mecay's project from wealthy individuals or private-equity funds.

Banks haven't totally abandoned construction lending, but they are much more restrictive, and some have temporary freezes on new real-estate loans. Many banks that formerly courted home builders are now short on capital and badly burned by their current loan books. As of Sept. 30, about 15% of real-estate construction and development loans were 90 days or more overdue at financial institutions whose deposits are insured by the Federal Deposit Insurance Corp., up from 1.9% two years earlier. Such loans outstanding have dropped to \$492 billion from \$616 billion two years before.

The financing drought is mainly hitting small and midsize builders. Major publicly traded home builders, by contrast, haven't needed to tap private equity because they have access to the public debt and equity markets, as well as lines of credit from banks.

At its annual convention in Las Vegas last month, the National Association of Home Builders set up booths for private-equity fund managers and other potential capital providers to meet with small builders are having trouble getting bank loans. More than 30 financial institutions and advisers took part in that event.

Many of the discussions there involved either loans or equity investments in land acquisition, development or building projects. "It's not inexpensive money, but it's available," says Don Faye, a part owner of a new San Diego company, Presidio Residential Capital, which so far has made two loans, totaling about \$17 million, to home builders and expects to make more soon.

Mr. Faye says many small builders are looking for very small loans of a few million dollars but Presidio doesn't want to get involved in transactions below \$10 million.

Unlike some banks, Presidio doesn't seek personal loan guarantees from the owners of home builders, Mr. Faye says. It does seek an indemnity against the risks of toxic material on the site.

Mr. Faye says the key to safe lending is to choose builders carefully and make sure the project is sound.

Within a few years, Mr. Faye says, banks will flock back into construction lending and bring interest rates down. For now, though, private-equity firms have a chance to earn high returns on building projects, assuming they back ones that pan out.

["The private lenders will have their heyday for the next 12 months, maybe 18 months," says Michael Maples, an owner of Trumark Cos., a small home builder based in Danville, Calif. Trumark is using a private-equity investment, rather than a bank loan, for a townhome project in the Granada Hills area of Los Angeles.](#)

While private-equity capital is more expensive, it often comes with fewer requirements for builders to provide documentation of construction costs and other items, says John Burns, chief executive of John Burns Real Estate Consulting.

Among the capital providers who showed up for the Las Vegas event was John A. Hay, a director of [KeyCorp's](#) Real Estate Capital unit, which manages a \$100 million private-equity fund focused on real estate. That fund already has taken equity in land-development ventures with regional builders under profit-sharing arrangements.

Now, Mr. Hay says, he is talking to smaller builders about similar deals. The fund aims for rates of return of at least 20%.