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High Hopes as Builders Bet on Skyscrapers

With Financing Scarce, Developers Use Their Own Cash to Wager on a Coming Resurgence in Office-Space Demand

By ANTON TROIANOVSKI

The office-vacancy rate in Rosslyn, Va., is one of the lowest in the Washington region, which may well be the healthiest office market in the country.

Even so, developer Anthony Westreich hasn't been able to secure a construction loan for a 35-story, $300 million office project on a prime piece of land in Rosslyn. But he says the partnership behind the project will break ground next month anyway and spend $30 million in cash to start construction—a risky bet on the local market and an illustration of just how hard it is to build a skyscraper these days.

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Monday Properties

Monday Properties will break ground on a Virginia skyscraper next month, with or without a construction loan

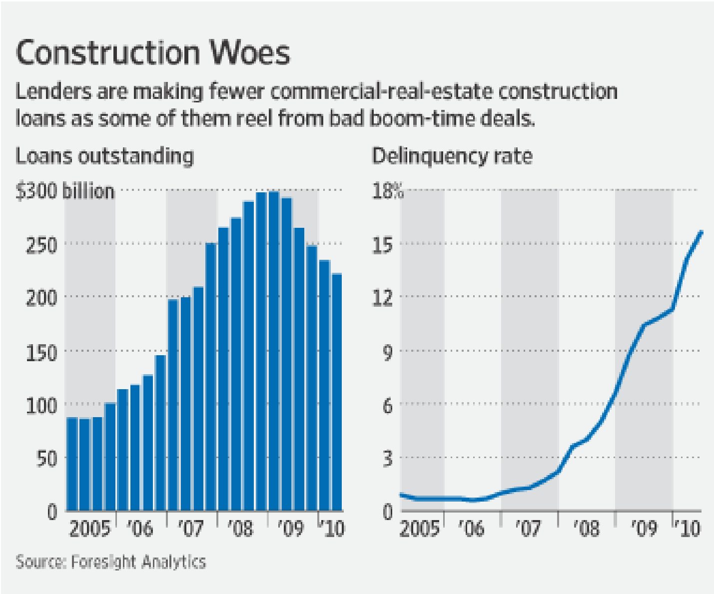
"It's a bit of a cart-and-horse situation," says Mr. Westreich, chief executive of closely held New York and Washington landlord Monday Properties. "You have tenants saying, 'I don't want to commit to a lease in your building until I know the financing is there,' and lenders saying, 'I don't want to commit to financing your building until I know the tenants are there.' "

The dearth of financing is forcing developers to get creative about ways to proceed with projects that have been languishing on the drawing board for years. During the boom, developers often were able to obtain financing for office-building or retail projects before signing tenants.

But ever since the recession hit, the financing spigot has run dry. Steep losses on top-of-the-market deals and a drop in demand for space have put have builders on the sidelines, while many lenders are swamped with boom-time loans gone bad.

Outstanding construction loans backing office buildings, shopping malls and other kinds of commercial real estate fell to a total of $221 billion in the second quarter of 2010, down from a peak of $298 billion in early 2009, according to data firm Foresight Analytics. The portion of those loans 30 days or more past due is up to 15.6%, nearly four times the rate two years ago. The nationwide vacancy rate for office buildings reached 17.4% in the second quarter, the highest level since 1993, according to research firm Reis Inc.

"I just don't see people taking risk," says Stephen Blank, who specializes in real-estate finance for the nonprofit Urban Land Institute. "Sure, people have short memories—but not that short."



The lack of financing and demand are among the reasons the construction industry is still in the doldrums. The Associated General Contractors of America says 245 out of 337 metropolitan areas lost construction jobs in the 12-month period that ended in August, with the unemployment rate in the construction industry remaining at nearly twice the national average. Demand for design services is still declining, according to the American Institute of Architects' billings index—a sign that an uptick in new construction isn't expected in the next nine to 12 months.

But some developers think all that gloom makes for opportunity, arguing that a lack of new construction means demand for state-of-the-art buildings could outstrip supply within a few years. In New York City, developer Douglas Durst is making the second bet of his career on constructing a major office building as much of the real-estate industry is still reeling from a downturn. He recently won a competition to invest about $100 million in the 1,776-foot-tall skyscraper being built by the Port Authority of New York and New Jersey on the site of the Sept. 11, 2001, terrorist attacks.

In the mid-1990s, Mr. Durst broke ground on a skyscraper in Times Square without having found any tenants and while many competitors were still struggling with the aftermath of the recession of the early 1990s. He secured an anchor tenant for the building, publisher Condé Nast, before it was completed in 1999.

"The theory in 1994 and now is that there are very few other buildings being built, and tenants always prefer a new building," Mr. Durst said in an interview. "The risk is that the downturn lasts longer and you come online with an empty building."

Other developers of new projects have been looking beyond banks for financing. Extell Development Co. has started construction on a 1,000-foot-tall residential tower in Manhattan, thanks in part to financing from partners in the Middle East. Extell says it is still working to secure a bank construction loan.

Developers in Dallas were able to start a 42-story condominium project this summer after granting 100% ownership to the local pension fund financing the project.

Outside Washington, Monday Properties' Mr. West reich also hopes to complete his building at a time when little new office space is on the market. Monday Properties and its majority partner, the estate of Lehman Brothers Holdings Inc., will spend $30 million in cash on building infrastructure and a four-story, below-grade parking garage over the next 12 to 14 months. Monday Properties says starting construction will help persuade tenants and lenders to sign on. That will allow the building to be completed as early as in 2013.

The project at 1812 North Moore St. in Rosslyn had been on hold for two years as the economy sputtered. Now, Mr. Westreich says he believes the timing is right, with his nine-building Rosslyn office portfolio 96% occupied and little construction being finished from 2011 to 2013.

"We think we're coming to the market at the exact right time," Mr. Westreich says. Monday Properties' tenants in Rosslyn include defense contractors Northrop Grumman Corp. and Raytheon Co., the U.S. State Department, and Allbritton Communications Co., which owns several television stations and Politico, the Beltway news outlet.

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