

EPISODE 1429

[INTRODUCTION]

Michael Zaransky (MZ): We've pivoted exclusively to doing ground-up new construction development because we find that if we underwrite it correctly, and minimize the risk of where we're building, that we can build a much higher yield than if we were to buy an existing building at today's yields and today's cap rates.

Whitney Sewell (WS): This is your daily Real Estate Syndication Show. I'm your host, Whitney Sewell. Our guest today, actually for numerous segments, is going to dive into development and ground-up construction. What is that? What are some things that you need to know whether you are an active operator or whether you are a passive investor, you're gonna learn a lot from these segments that are crucially important as you invest in ground up and new construction. His name is Michael Zaransky. He's the founder and Managing Partner of MZ Capital Partners. He specializes in ground-up construction that caters to by-choice renters and workforce housing, by strategically building with their target demo in mind adding over-the-top amenities and keeping it at an affordable price. MZ Capital has successfully taken a projected 18-months stabilization forecast down to 100% occupancy on a 100-plus unit complex in under 90 days. And I hope you just heard that I mean, that's typically not heard of, but he's gonna go into that we're going to talk about that in one of the segments.

WS: He's also published numerous articles and lectured nationally in real estate investments. He's written books, numerous books, and one called "Profit by Investing in Student Housing" and "Purchase, Rehab and Reposition Commercial Investment Property", real estate category best sellers published by Kaplan Publishing, and sold obviously on Amazon, major bookstores and sellers. But you are gonna learn a lot from Michael today, if you are like I said, if you're an active operator, you are passive, either one, you're gonna learn a lot from this segment of interviews with Michael, going into the dos and don'ts about many different aspects of ground up. There's gonna be some preliminary stuff we're gonna talk about ground up, we're gonna get into government approvals and entitlements and how they do it, how they're proactive and making that happen. You're gonna learn a lot, and then even amenities, what works, what

doesn't, and why. And then even getting to why certain submarkets might work and why not as well, and how they look at the exact market they're gonna go into, You're gonna learn a lot today from Michael.

[INTERVIEW]

WS: Michael, welcome to this show. Honored to have you on. It's not often we have guys on who are experts in development or ground-up construction. And so I'm looking forward to diving into that. I know, there are a lot of listeners who are thinking, hey, maybe I could do that sometime in the future. Is that for me? Or what is it really, you know, or how do I learn how to do that? And I know we're gonna dive into some of that with you. So, welcome. Let's dive into who Michael is, though first, and we'll get into what is ground-up construction. How did you get into ground-up construction, give us some background.

MZ: Sure. My firm is based in the Chicago metropolitan area, MZ Capital Partners. We are a multi-generational firm. My son is the fourth generation in our family to be in real estate, multifamily apartments. He's a member of our firm, a principal in our firm. So, I'm the third generation. And I've been through the gamut over the years of various aspects and pivoted as time has changed in the real estate business, focusing on multifamily but writing the condominium conversion phase, the renovation of apartments, buying existing stabilized properties and getting value and improving them, as well as doing brand new construction projects, largely of garden-style suburban communities with a number of buildings and clubhouses and onsite management.

We have found, given the market and given the valuations, that existing stabilized properties are bringing that very low cap rates. And in the last five years or so we've pivoted exclusively to doing ground-up new construction development because we find that if we underwrite it correctly, and minimize the risk of where we're building, that we can build a much higher yield than if we were to buy an existing building at today's yields and today's cap rates.

WS: Okay, that's incredible. I want to jump into that, and just how you have lowered the risk. And you know, and how you're, you're that I mean, now a lot of that focus on whatever it may be as well, like we believe this, we know this, this is why we're moving this direction. And so I want to jump into that. But first, what does that mean to you, you know, somebody says ground up construction. And you know, maybe we can talk about that. You've all done different things in real estate, especially over, you know, the fourth generation is now a part of the business. That's incredible, by the way. No doubt you all had your hand and lots of different asset classes potentially or done different things, but maybe speak to ground up construction versus heavy renovations, you know, and just what ground-up construction is.

MZ: Right? Well, I mean, the obvious differentiating factor and starting point is in buying an existing building with heavy renovation, you're working with an in-place infrastructure, in-place ceiling heights, in place sewer and water capacity, walls bearing walls. And you're kind of limited as to what you can do. One of the things that I love about ground-up new construction is that we're really dealing with a blank slate. So we're able to create a property with the amenities and with the structure that appeals to today's top amenities and what renters are looking for.

MZ: We typically find and purchase either a raw piece of land, which is in the areas we like to develop, kind of rare, or a piece of land that has a use on it that's really either obsolete, or no longer producing enough revenue. We bought properties that have rundown motels on them and wreck them. We bought properties that have tire repair center and wreck them. And occasionally we find a true piece of raw land improvement and literally start from the ground up, which is why it's called ground-up new construction, and put in the infrastructure, including the sewer and water capacity and electric capacity, the underground lines that go into the foundation of the buildings, and then design buildings and amenities that meet today's standards, what renters are searching for?

WS: Yeah, that's awesome. Like you mentioned, there's already some kind of structure there, you're kind of having to start before the ground up, right? I mean, you're having to demolish something or demo something and go through a big process before even being able to start

your project, potentially, you know, you mentioned putting in sewer and infrastructure and those processes. I want to get into those as well. But maybe, you know, as we do that, you could walk listeners through some steps involved in, you know, building up, ground-up commercial building, and even maybe even start like with that tire business or whatever it was, you know, you're having to remove that structure potentially, I'm sure there's things you're having to consider as you're thinking about this, this old business that were they're just thinking about whether your fuel stations and things like that, that have stuff underground and oh, man, there's many things you're gonna have to think through before maybe you build a residential property there, right? And so maybe you walk us through some of those steps that are involved in ground-up commercial and what the listeners should be thinking about, especially if they're considering moving into that asset class or being able to start to ground up on their own when maybe they've been debt buying existing multifamily or something like that.

MZ: Yes, there's a lot. And you mentioned some of the concerns, there are many concerns from start to finish even to get into the breaking ground stage. And typically, unlike starting with an existing structure, where once you close, you actually have the keys and you have a revenue-producing property. There's a very long timeline in the development process. And the first part or some of the things that you referred to is the pre-development stage, which takes a number of months. It takes a number of months after getting a piece of property tied up on a contract with some due diligence period, putting up some earnest money, to do the due diligence necessary to see what will fit on the land, to actually spend some money with engineers to look at that and those infrastructure needs. Spend some money with an architect or some preliminary plans as to what can be built.

MZ: And as you mentioned, one of those items is environmental issues. The tire repair place is an obvious one, but any piece of land that's going to be reused requires at least a Phase One. And then if there are issues going on, or phase two, and perhaps still drilling some borings to make sure there's nothing miserable underneath the ground and cleaned up and then needs to be factored in the cost. It's also important, regardless of the environmental condition of the site, to do soil sampling, and borings for our construction crews, and our general contractor, to be able to assess the ability to build the foundation, and how big of a building that ground will

support. It's one of the due diligence items we look at. We spend a lot of time throughout the process, typically working with a local municipality to make sure they're receptive to the concept of multifamily. And in almost 100% of the cases, it's very, very rare to find a site that is fully zoned and entitled as a matter of right to support a multifamily use. So, getting the entitlements from the local municipality and going through their process is also part of that due diligence period.

MZ: When getting to ground-up construction like I'm describing and becoming a developer, there are considerable pre-development costs, we call them chase costs. Some of the things I outlined that you just have to go at risk for in advance, and knowing that there's a possibility that you may have a deal that for whatever reason does not move forward. That's certainly one of the risks and it requires some initial capital that you're willing to risk on the deal. The deal goes, you can absorb it, but if it doesn't, well, you've got to write it off as chase costs.

WS: Yeah, that's so many things to think through. And now we're gonna talk about a number of them, or we're, you know, a series of shows here. But that's a great start. And to help us start thinking about that, and I think that's probably one of those risks, right? Or something, especially someone getting started, you know, is considering when they think about those pre-development or chase costs? And can you speak to, as far as maybe there's a way that you could give us to help think through what to expect on those costs? I know, it could be some in the air, you know, so much in the air about what might happen, what might have to be done, depending on the project itself, is there a way up front, though, because I know, you don't always know exactly what you're getting into right, when you may begin a process like that. But how do you all, I guess, justify and think through the risk of the amount of that pre-development cost?

MZ: Well, the first thing we do because of those costs, and it's hard, as you mentioned, to exactly quantify, but we have a general idea, having done this a number of times about what it would cost per deal, which I'll share in a minute. But one of the things we do before we start pulling the trigger on spending money is do a couple of things to help ensure our success. The first is we look at the market that we've targeted and we make sure that existing rent levels are

at a sufficiently high margin, that it can be profitable to build and move forward with the project. We also look at occupancy rates of other existing apartment communities in the submarket to make sure that they're running at high occupancy levels. And there's not a lot of vacancy, which tells us that there's demand in the marketplace for it.

MZ: And then we, of course, first deal with the sellers of the properties that we're engaged in. And the good news and the bad news is, it's sometimes a lengthy process to get under contract and to convince them to go under contract with a due diligence period that is typically longer than a straight-up sale of a stabilized product. That's because we need time for all these things and to put up some earnest money with them that's refundable up to the due diligence period. But the good news is that after you get past that hurdle, that we have a seller that understands the process and why it takes time, you have time internally to figure these things out and to gradually pull the trigger on expenses, rather than diving in all at once to gradually take it a step at a time.

MZ: So after we take care of getting comfortable with the market, and actually tying up the land, we will actually go on, we've learned to make a call to the director of planning or development at the local municipality we're dealing with. We usually go in person and have a meeting and share our plans for the site and get a reaction from the city whether or not they'd be amenable to it. They sometimes don't tell you on the spot, but they'll get back to you after they've talked to some other people on the planning commission and after they've talked to their local city council. That feedback is very, very important because in our case, if we get feedback back from the city, that they have no interest in multifamily on that particular piece or they're not willing to support it, we actually pull the plug at that point before we start spending money. We have found the old saying, "You can't fight city hall", all to be true and we only move forward with a project and go through all the various steps that we know that at least the planning department in the city will support our project and our concept.

WS: That makes a lot of sense. I'm looking forward to getting into that even more in the next segment. We're going to talk a lot about the local government and approvals, entitlements and some of those things even more. I wanted to ask you though, you mentioned and I know most

listeners are going to know some of this, but you mentioned a long timeline, right? Could you just give some details around maybe some projects, why they were a faster timeline, or maybe why some really dragged out longer than you all expected?

MZ: Sure, I think most of that has to do not with the professional services. Once we get going with our architect and engineer, they can work very fast and keep the timeline going as quickly as possible. Internally, we can do things as quickly as possible. No matter how much due diligence we need to do, it can get done fairly quickly. The timeline for a project is really, for us, at least in my experience, more contingent on the responsiveness and the turnaround time, so the city or municipality we're dealing with. A lot of them want to see preliminary plans or even final engineering plans before they'll let you apply for a hearing for a zoning change. And sometimes they have a comment period that if they're backlogged or have a very small staff, or have a lot of other projects can be a couple of months. And sometimes they work very quickly and it could be a couple of weeks.

MZ: So it's really an unknown when you're getting into it. But generally, when you have a city on board and enthused about a project, we find them, in our professionals work with the staff, we find them to be reasonably diligent and receptive. The other thing that matters a lot is we can get into it is a topic in and of itself is the public hearing process and the neighbors and maneuvering through that process and getting them on board. That sometimes can delay a project or not. We try and make that as smooth as possible. So it really is dependent on the reaction of the city we're dealing with. And also, frankly, where the site is if it's in a commercial area, or what was formerly a commercial area, and there aren't a lot of residential neighbors, it usually goes quicker. If there are residential neighbors, they rightfully want to know a lot of details about the project that come to public hearings, and the process is longer.

WS: Okay, now, that's awesome. And we may talk about the public hearing process a little more, as well. I feel like it's a very important part of the process. And so at least knowing that upfront funding on the type of project or location, but also, you know, when you're thinking about all these expenses, all these things you're having to do in the pre-development stage,

you know, or the chase costs. What's the timeline of that, and say, getting a project under contract typically?

MZ: Let me give you an example we're currently working on a project that also happens to be in suburban Chicago, although we do other markets as well. We went under contract for the property, it was a three-parcel assemblage with two sellers; one seller was more difficult than the other in terms of the contract, and some of the back and forth with turns that took about two and a half months to get under contract by the first of the year. This year, we were under contract on the properties, and met with the village the second week of January. We engaged our consultants, and we just, one week ago in August of '22, received our final approval from their city council. So, from start to finish, eight months in '22 to about three months in '21 of negotiating with the seller. So, it's 11 months. We'll close on that property in October and begin moving dirt and doing site work in October. And it'll take about 12 to 15 months to build it. So, looking at quite a timeline and quite an investment. A couple of years from start to finish to start pre-leasing. But as I mentioned, we find that the time and the commitment to it is well worth it in terms of the meal versus buying an existing property.

WS: Speak also to you had mentioned early on about why you all like ground-up, you talked about the lowered risk, the business plan or the location, those things. Could you elaborate on that?

MZ: Sure. We do a fair amount of detailed analysis and we only operate in sub-markets that we've been in and are really comfortable with knowing the market odd. And then we can use outside third-party sources to support our own research. We, fortunately, are all now in an industry where there's lots of data available, accurate data through places like Costar and some others where there's really comprehensive reporting on rent rates. And then apartments.com which happens to be owned by Costar, a great place to rent surveys in any sub-market and draw a little map around our site and go out one mile three miles or five miles and identify virtually every apartment complex there is. There's data on the age of those properties nowadays and the rent, you can quickly figure out what rent per square foot is in that market so that we can begin a pro forma income and expense statement.

MZ: And we actually, once we get to the stage where we're rolling, we're starting to spend money on engineering and architectural plans. We get our general contractor involved in pricing and we also engage one of several third-party independent market research firms that do a market study for us. They really are relatively cost-effective, not as much as someone that think that great data on the market, but the future demand is on employment trends on rents, and they confirm our rent assumptions. Also, very, very useful report to have when it comes time now for making a presentation to the lenders for financing for the project, where, instead of just listening to the developer's story, the bank can rely on independent third parties' data and analysis. And that gives us a really good feeling for at least in today's dollars, what our revenue will be, once the project is finished. We then obviously have to construct on the income and expense statement, the expense side of it, we're pretty good at that. So our appraisers that we have relationships with, because of the number of properties we operate in, we have an idea of what it costs in each category to operate in today's dollars, a finished community and from that we have come up with a realistic projection of what net operating income will be.

WS: Speak to, you know, maybe the listener who is looking, again, at getting into this space, and maybe just a couple tips on alleviating as much downside or risk potential as they can, as far as learning ground up as they begin the process.

MZ: I think the best way to learn as I did, and I think, you know, just kind of intuitive, if we think about it, is regardless of your financial ability or your ability to attract equity or debt, I would do something small. I would do a project small and learn about all these pieces, you know, maybe do a six-unit building in an environment where there are other similar size departments or similar-sized buildings, perhaps it's an easier small site to find something that's already zoned. So you eliminate that whole process of entitlements that I talked about, just so you can roll up your sleeves and get going. And use that to kind of hone the skills. And get a good architect, you know, a good engineering firm on board, and a professional team that can help you marshal the project. I would definitely start small.

And the quick, what I call like, the back of the envelope down and dirty, that we always use to check our deals is you'll be able to get an idea and reach a point of how much per unit it costs to build the thing. And once you have that number, do your research in the market, talk to brokers, look at recorded sales and see what other buildings are selling for on a per unit basis. And if your cost to construct is lower than the selling price, which I think you'll find in today's market, you've got yourself a winner and you've got the downside risk covered. So despite the elaborate method I just went through, that's always my due call.

WS: Yeah. Now that's awesome. No doubt, you've learned so much and less risk less capital involved. And you talked about potentially even buying the land after it's been entitled. And you know, it would you say that say, as far as buying the land after it's been entitled, that means that somebody else has really taken a lot of that chase cost risk, the pre-development cost risk. They've purchased that land, they've gone through that process, and then they're going to sell it to somebody that's going to do the actual development piece then, right? So, they're gonna make some profit on that and then maybe hand it off to somebody that wants to take it the rest of the way. Is that correct?

MZ: There is a market for that; there are several markets where there are developers that will do that. We don't. I've never been comfortable with the risk of closing on a piece of land until it's vital. But if somebody had the ability and the risk tolerance to do that, there was no question that a piece of land is worth a lot more after it is zoned for multifamily and through the entitlement process than it was when it was initially bought.

WS: Okay, now that's awesome. Well, Michael, great first segment. Just really helping us dive into some of the things we should be thinking about as we learn about ground-up construction development and maybe the listeners thinking about adding this to their portfolio or maybe the passive investor is even considering investing in a project like this. And it's gonna help them to have better questions to ask that operator as well, right? As far as ensuring that the operator has this experience, at least on their team, or they've thought through these things. And so it's been helpful, to say the least. Looking forward to getting in the next segment also so we can dive into the local government approvals and entitlements and what that looks like. We've

mentioned a little bit about it, but it's a delicate process as well. And so I want to dive into that in just a moment. But Michael, thank you again, and we will talk to you again tomorrow.

MZ: Thank you, Whitney. Take care.

[END OF INTERVIEW]

[OUTRO]

Whitney Sewell: Thank you for being with us again today, I hope that you have learned a lot from the show. Don't forget to like and subscribe. I hope you're telling your friends about the Real Estate Syndication Show and how they can also build wealth in real estate. You can also go to LifeBridgeCapital.com and start investing today.

[END]