

Analysis of Acquisition, Development, & Construction Lending Compared to Other CRE Asset Classes

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Introduction

While the U.S. for-sale housing market is one of the largest asset classes in the country, it remains undercapitalized by institutional investors.

- **Total value of U.S. for-sale housing market:** ~\$45 trillion, data from the Federal Reserve and John Burns Research.
- **New homes sold annually:** ~\$1.1 trillion, based on Census Bureau and industry reports.
- **Institutional capital penetration:** Still relatively low compared to income-producing Commercial Real Estate (CRE).

Given this scale, there is significant room for institutional capital to invest in the US for-sale housing market. One compelling strategy to consider is Acquisition, Development, and Construction (AD&C) lending. This paper examines the risk-return profile of AD&C and compares it to other CRE asset classes.

Investment Thesis

The compelling case for AD&C lending rests on three fundamental pillars: supply-demand dynamics, regulatory framework advantages, and superior risk-adjusted returns compared to alternative investments. Each of these factors contributes to creating an attractive investment opportunity in the current market environment.

Background

The U.S. residential real estate market stands as one of the largest asset classes globally yet remains surprisingly underpenetrated by institutional capital. According to Federal Reserve and John Burns Research data, the total market value approaches \$45 trillion, with annual new home sales reaching approximately \$1.1 trillion as reported by the Census Bureau. While institutional investors have heavily invested in traditional commercial real estate sectors - the "four main food groups" of office, industrial, retail, and multifamily - along with emerging sectors such as data centers, hospitality, and self-storage, the for-sale housing market remains predominantly financed through traditional channels. This disparity creates a unique opportunity for sophisticated investors to enter a massive market with relatively limited institutional competition.

Structural Market Dynamics

US Housing Shortage

The U.S. housing market currently faces a structural deficit estimated at 6.5 million units, a situation that has developed over many years and continues to worsen. This shortage stems from multiple factors working in concert: strong demographic tailwinds as millennials enter their prime homebuying years, persistent barriers to new development that constrain supply, and sustained household formation driven by both domestic population growth and immigration.

Perhaps most critically, the market faces a severe shortage of vacant developed lots (VDLs), which serves as a fundamental constraint on new housing supply. Traditional financing constraints have further limited developers' ability to create new lot inventory, creating a bottleneck in the housing supply chain that AD&C lending can help address.

Why Homebuilders Can Absorb Rising Interest Rates

Despite rising mortgage rates, homebuilders continue to maintain 20%+ margins, as reported in the February 2025 Burns Homebuilder Survey. This allows them to:

- Offer mortgage rate buy-downs to consumers, insulating demand.
- Adjust pricing dynamically based on supply constraints.

Homebuilders also benefit from historically low resale home inventory, which supports new home sales.

Lack of Institutional Capital

Institutional lenders have largely exited the AD&C lending sector, creating an environment with minimal competition and elevated return potential. Unlike standard commercial real estate loans on stabilized office, retail, or industrial properties—where significant institutional competition keeps lending rates low—there is relatively little institutional capital available for smaller land developers. This scarcity of financing allows private lenders to command significantly higher interest rates.

This retreat of institutional lenders was further exacerbated by the failures of regional banks such as Silicon Valley Bank, First Republic Bank, and others, which traditionally had a larger role in financing land developers. These failures have intensified the capital constraints on banks, (described below) further reducing lending capacity in the sector.

Regulatory Framework and Market Opportunity

The current regulatory environment has created significant market inefficiencies in the

AD&C lending space, primarily through the complex and costly requirements imposed by the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). Understanding these regulatory constraints is crucial to appreciating the opportunity they create for alternative lenders.

OCC Regulatory Requirements

The OCC has established a particularly stringent framework for AD&C lending that significantly impacts traditional banks' ability to participate in this market. Reserve requirements for AD&C loans substantially exceed those for other lending categories, requiring banks to maintain higher capital levels against these assets. The loan grading system poses another significant challenge, as even loans to well-capitalized borrowers rarely achieve ratings above 'Standard Pass' - just one step above 'Watch' status. This proximity to potential downgrades creates ongoing monitoring costs and operational challenges for banks.

The grading system's rigidity manifests in quick downgrades for even minor issues or delays, often leading to permanent relationship impacts when loans are downgraded to 'Special Mention' or 'Substandard' status. These downgrades trigger enhanced monitoring requirements, increased reserve requirements, and often result in the permanent severance of lending relationships, regardless of the ultimate resolution of the triggering issues.

FDIC Regulatory Impact

The FDIC's regulatory framework adds another layer of complexity and cost to AD&C lending for traditional banks. FDIC-related expenses typically represent approximately half of the total operating costs for banks' AD&C lending groups, a proportion significantly higher than in other lending divisions. This cost burden stems from multiple factors, including higher assessment rates tied to perceived portfolio risk and additional premiums charged for concentrated AD&C exposure.

Capital requirements present another significant hurdle, as AD&C loans carry higher risk-weightings that impact banks' overall capital planning and stress testing requirements. The FDIC's examination process places particular emphasis on AD&C portfolios, requiring enhanced documentation standards and regular market analysis that further increase operational costs.

Market Impact of Regulatory Framework

These regulatory constraints have led to a broad retreat of traditional lenders from the AD&C space, a trend accelerated by recent regional bank failures such as Silicon Valley

Bank and First Republic Bank. This exodus has created a significant opportunity for alternative lenders who can operate outside the traditional banking regulatory framework. The reduced competition allows these lenders to command premium pricing while building strong relationships with quality borrowers who find themselves increasingly underserved by traditional banks.

Comparative Risk Analysis

When evaluating AD&C lending against alternative real estate debt investments, several distinct advantages emerge. This analysis compares AD&C lending with two primary competing strategies: non-performing CRE loans and multifamily construction lending, revealing important differences in risk profiles, return expectations, and investment characteristics.

AD&C lending typically generates mid-to-high teens IRR with a relatively short investment period of two to three years. This return profile contrasts favorably with non-performing CRE loans, which often target opportunistic returns exceeding 20% IRR but require lengthy workout periods and face significant execution uncertainty. Multifamily construction lending, while similar in duration to AD&C lending, generally produces lower returns in the high single digits to low teens, primarily due to intense competition in the sector.

The collateral position in AD&C lending provides another significant advantage. These loans typically maintain a first-lien position with loan-to-cost ratios ranging from 50% to 75%, offering substantial protective equity cushions. Non-performing CRE loans, conversely, often involve complicated capital structures with subordinated positions, while multifamily construction loans typically feature higher loan-to-cost ratios of 65% to 80%, providing less cushion against potential market corrections.

Market correlation represents another crucial differentiating factor. AD&C lending performance correlates primarily with housing supply dynamics, which have demonstrated remarkable stability due to structural undersupply in the market. This contrasts with non-performing CRE loans, which remain highly susceptible to tenant demand cycles, and multifamily construction lending, which faces exposure to rental market fluctuations and interest rate sensitivity.

Risk Mitigation

AD&C Risk Mitigation

Despite the categorization of AD&C loans as higher risk by the OCC, there are a variety of risk mitigation strategies that can be employed by experienced private lenders, including:

- **Secondary Credit Support:** There is always a guarantor in an AD&C loan,

providing additional security. In contrast, CRE loans often do not have a reputable guarantor.

- **Structured Loan Terms:** Loans are structured with favorable provisions such as completion guarantees, corporate and personal repayment guarantees, and interest carry reserves.

Unique Risk Mitigation from Avila Real Estate Capital (AREC) Debt Fund

In addition to the structural risk mitigation provided by AD&C loan structures, AREC Debt Fund provides additional risk mitigation, including:

- **No Leverage:** The Fund does not use leverage at either the transaction or portfolio level, reducing exposure to market fluctuations.
- **Workout and Takeover Capabilities:** Unlike traditional banks, AREC has the ability to perform workouts or take over distressed projects through its in-house land development and construction team.
- **Builder Relationships:** AREC leverages its strong relationships with national and regional builders to assess the likelihood of successful project execution and lot absorption.
- **Interest Reserves:** Borrowers are required to fund 9-12 months of interest reserves, ensuring payments remain current even in adverse market conditions.
- **Diversification and Concentration Limits:** No single loan exceeds 30% of the Fund's portfolio, limiting exposure to any one borrower or project.
- **Interest Rate Floors:** Transactions include interest rate floors to mitigate the impact of declining rates on expected returns.

Conclusion

AD&C lending provides a more predictable, lower-risk pathway to earning high-yielding real estate debt returns. With a deep and persistent U.S. housing shortage, high builder margins, and homebuilders' ability to mitigate interest rate pressures, AD&C lending presents an attractive alternative to the uncertainty and complexity of investing in distressed commercial real estate loans. Investors seeking strong risk-adjusted returns with shorter holding periods and structural demand tailwinds should consider AD&C lending as a compelling investment strategy to access the \$45T+ US for-sale housing market.