In Albuquerque, New Mexico, the Gold Avenue Lofts mixed-use project covers 12,000 square feet downtown.

JILL ANNARINO / THE DESIGN GROUP

Rethinking expanding conventional development forms could broaden investor focus and benefit the built environment

Financing Mixed-Use

CHRISTOPHER B. LEINBERGER
AND HOWARD KOZLOFF

JILL ANNARINO / THE DESIGN GROUP

Projects like the Gold Avenue Lofts seek to create center city life.

For progress to take place, creative approaches to problem solving must be encouraged. In real estate, while innovative thinking has inspired rediscovery of one real estate sector—mixed use—conservatism in the financing sector has hindered its progress.

Proponents of community building, environmental sustainability, and multiple transportation options have embraced mixed-use, pedestrian-oriented developments as an alternative to sprawl. While mixed-use development comes in a variety of product types, the overall goal is to create city life—the mix of activities and users that makes an area seem to be continuously busy. Variations include an infill project in an urban setting, a redevelopment project in an established suburb, or an entirely new neighborhood on a greenfield site.

Almost invariably, these projects include a residential component—high-end units combined with a luxury hotel, apartments above commercial space, or, most likely, residential units above retail stores. Regardless of form or combination of components, mixed-use projects share the common objective of combining a variety of uses into one project. The subsequent quest is to enable users to exist in a 24/7 work, live, and play environment. Despite their apparent benefits, these developments face many hurdles as the "new kids" on the real estate industry block.

The basic problem lies in the premise of conventional investment practices. Conventional development has been codified into 19 standard product types. These product types, which have defined America's built environment during the past half century, include regional malls, neighborhood centers, power centers, office parks, and walkup apartments, as well as low-density, for-sale housing tracts, among others. Mixed-use projects do not fit into these standardized financing categories; therefore, such projects are deemed risky, leading to increased costs of financing. The financial profile of progressive development does not fit the criteria uniformly employed today in evaluating prospective real estate investments. A distinct need exists to broaden the scope of the 19 standard product types because there is market demand and public-policy justification for mixed-use, pedestrian-oriented projects, such as retail space on the ground level with live/work space above.

Many believe development of mixed-use projects will help alleviate some ills brought on by suburban sprawl, urban decay, and the accepted practice of segregating uses. Furthermore, the common practice of including residential units—whether affordable, market-rate, or luxury—in mixed-use projects helps to chip away at the nation's severe housing shortage. Therefore, these projects are generally considered to contribute to a city's health. But bringing them to reality is difficult. Although the success of some mixed-use projects has helped somewhat, the preoccupation in the financial industry with standardization results in a process that is time consuming, expensive, and unpredictable—all of which can wreak havoc on the financing of a development project.

Financial Markets Drive Development

Developers and architects can design and propose mixed-use projects big and small, and local governments can adopt policies to promote such construction, but in the end, if the developer cannot obtain investment capital, the project cannot be built. In the financial markets, an investor bias exists toward trading similar products, thereby treating them as commodities. Such standardization allows the buying and selling of products from afar, without necessarily having to "kick the tires." Real estate is not exempt from this bias. Investment bankers, like agricultural commodity traders, have been trained to think of standardization as a way to minimize risk. As a result, when a new product is introduced, it is perceived to carry with it increased risk, making it less attractive to potential investors—a bias that favors conventional development and places mixed-use developments at a competitive disadvantage.

Adoption of the short list of 19 real estate products acceptable to financial market makers has been driven by the desire for conformity, which, when combined with discounted cash flow methodologies that focus on short-term returns, has led to an investment environment in which sprawling strip commercial space and subdivision housing are the preferred investment types. While the list of acceptable products will change in response to market conditions in certain places or overbuilding in certain products, it usually holds steady. Of the standard income-oriented products, all but two—urban entertainment and high-density rental apartments—must be located along or near strip commercial corridors, and, therefore, produce sprawl. And most urban entertainment and high-density apartments are built along sprawling strip commercial corridors anyway.

In the relatively recent past, real estate investment trusts (REITs) became a driving force in real estate investment. Because REITs are publicly traded and must create investment portfolios that can be bought and sold, they tend to focus on investing in one of the 19 standard product types, which serves to perpetuate the narrow focus of investors. Conventional development is well understood, relatively easy to finance, simple to build, and modular in nature, so it does not need to relate to the surrounding built environment. In the eyes of investors, the reduction of risk far outweighs the consequences such development has on its environs.

Innovative mixed-use projects generally help to curb sprawl and offer a variety of alternatives for live, work, and play areas within a relatively compact pattern, thus creating pedestrian-oriented environments. To have such alternatives, a multitude of different shops, hotels, offices, housing, public institutions, and other attractions must be offered to help create a safe pedestrian environment. Although cars still dominate transportation with mixed-use development, multiple transportation options also must be provided. Also, to make the development truly pedestrian oriented, many of the cars using it must be parked in parking structures, which are substantially more expensive to build than surface lots.

As a result of these issues, as well as others, it is more expensive to build mixed-use developments than single-use projects. Regardless, mixed uses appear to have market, environmental, and public-policy support throughout the country. Once a pedestrian-oriented district is established, the real estate value tends to climb past values in other parts of the metropolitan area. As evidence, the few vital downtowns in the country that survived the post–World War II years—midtown Manhattan, San Francisco, Chicago, and Boston—have almost always commanded among the highest commercial, retail, and residential rates in the country and their respective metropolitan areas. Pedestrian orientation also yields higher medium- and long-term returns and has a longer life than its

Modern Adaptations

The Greenwich Street Project, a six-story former brick-faced warehouse on Greenwich Street in Manhattan, is a residential conversion that is anything but typical. With the integration of an 11-story addition comprising a glass-and-steel facade, architect Winka Dubbledam and developer Jonathon Carroll are transforming the former industrial space into 26 luxury loft units to sell for about $2 million each. Featured amenities include a multilevel fitness center, and a wine storage area and a garden shared by the units. Units will be equipped for Internet, cable, and telephone wiring.

The site design works to meld old and new architectural features, technical innovation, and traditional construction techniques, as well as public and private spaces. When gutted, the former warehouse will provide enlarged interior spaces allowing the incorporation of an open loft plan. Each unit has large solariums derived from the structure's translucent skin, plus accordionlike folds designed to accommodate setbacks to meet city zoning requirements.

In addition to flooding the units with light, modern technology has allowed creation of unique spaces. For instance, a triplex unit has been formed, projecting five stories from the left side of the brick building. Outside decking is used to integrate the old and new facades, as well as to merge the public and private spaces by bringing the building's interior toward the street.

The project site lies at the crossroads of three downtown cultural districts: to the north are the residences and cafés of West Village, to the east is the fashionable commercial district of SoHo, and to the south is the financier- and entrepreneur-populated area of Tribeca. Within this eclectic environment, the Greenwich Street Project is being built on and complements the existing property. As the structure emerges from its industrial past, it provides "the chance to investigate the idea of juxtaposing old and new to reinvigorate the neighborhood with an innovative, forward-looking building," Carroll says.—**Erinn Dowling,** *a former ULI intern who is pursuing a master of city planning degree at the University of Pennsylvania*

conventional counterparts. Downtowns revived in the past decade—such as Denver, Portland, Seattle, and San Diego, among many others—have demonstrated that the highest real estate value ratios in their metropolitan areas now are in their downtowns.

Conventional investors generally do not recognize the medium- to long-term value of pedestrian-oriented downtowns. If the presence of a medium- and long-term investment market can be revealed, however, perhaps investors would recognize that such returns are better and longer lasting than conventional investments in the 19 standard products currently most favored. Once revealed, a revised investment approach could lead to more investment dollars being diverted into mixed-use projects in pedestrian-oriented districts.

Short-Term Views Create Long-Term Problems

The currently accepted methods for comparing alternative investments include discounted cash flow (DCF) and its various derivatives, such as net present value (NPV) and internal rate of return (IRR). While these methodologies work very well for short-term investments—that is, less than five years—real estate has always been a long-term asset class. The fact that the Internal Revenue Service

Though medium- and long-term mixed-use developments cost more to build, they tend to offer higher and longer-lasting yields than their conventional counterparts.

(IRS) allows depreciation of real estate over 37 years is one indicator of the long-term nature of the business. The short-term bias in the IRR methodology means that industry analysts undervalue the "sweet spot" of mixed-use, pedestrian-oriented real estate investing for the medium and long term. The lack of a financial evaluation methodology that measures medium- and long-term cash flow translates into a lack of inducement to build for the medium or long term. IRR blinds investors to the returns generated by urban real estate as it matures and generates stronger cash flow over time.

The primary way conventional real estate developers achieve higher IRRs is to reduce construction costs. However, this shortens the productive life of the development as well as reduces the likelihood that it will provide the high-quality experience that mixed-use projects seek for pedestrians.

In spite of the common-sense conclusion that real estate by its very nature should be productive for generations—a motivation behind real estate investment for centuries before the invention of DCF methodologies—current equity investments must be paid off and make the targeted IRR within three to five years of the initial investment. This measurement methodology, considered sophisticated and unassailable, has limited the financial power of this 37-year asset class, and has created a throwaway built environment, creating myriad negative social, environmental, and financial consequences.

If the decision is made not to reinvest in a conventional development after its intended five- to seven-year life span, the project can decline in quality and value, particularly if sprawl has continued to move demand farther to the fringe. This may lead to a reduction of reinvestment in the project, which then leads to a lack of investment in the surrounding neighborhood.

The irony is that though consumers have a vast number of choices in supermarkets, for example, real estate investors have only one type of financial return—short-term cash flow that must be constantly reinvested. Many investors would prefer medium- to long-term investments that can gain substantial value because of intrinsic attributes, such as high-quality construction, location, and the emotional connection that architecture and pedestrian orientation create in consumers. The financial underwriting of conventional development implies that investors must accept one-size-fits-all, short-term logic because DCF ignores medium- and long-term returns.

Match Investors with Appropriate Types of Returns

Different types of real estate investors have different needs. On the debt side, some banks by regulation must make construction loans for a short period of time. Some institutions will make permanent loans that they will keep in their own portfolio or sell to the secondary loan market. On the equity side, publicly traded REITs have a short-, medium-, and long-term need for sustainable cash flow. Foundations, university endowments, insurance companies, and pension funds also have well-defined, predictable short-, medium-, and long-term cash flow needs. Individual and family investors often look ahead many generations for sustainable returns. Most of these investors, however, use the same short term–biased, DCF-based methodology and the same list of conforming standard products when evaluating real estate investments.

To meet the needs of various investors, funding sources with similar investment horizons could be grouped to finance various components of a project's equity needs through time "tranches" matching investors with the appropriate "slice" of an investment. The various cost elements of a project could be divided into three categories—short term (one to five years), medium term (six to 12 years), and long term (more than 12 years).

With this approach, short-term investors who want to get in and out within five years would receive the bulk of the cash flow during the first five years of a project's life. The second time tranche would pay the medium-term equity investors most of their cash flow after investors in the first tranche have achieved their expected returns. Finally, investors in the third time tranche would receive the bulk of their returns in the long term. This final tranche most likely would be composed of public entities that have alternative financial return mechanisms, such as tax revenue, and public-policy motivations, such as a desire to revitalize a section of a city. To them, this nonfinancial compensation might be as important as, or more important than, the financial compensation.

Progress toward Progressive Development

Trends are starting to emerge indicating that mixed-use, pedestrian-oriented projects are outperforming some of their single-use counterparts in terms of lease rates, residential rents and sales, and retail sales. This translates into increased tax revenue for municipalities, making them more likely to adopt policies that encourage such projects. Basic real estate fundamentals still apply: market demand must exist, an experienced developer must run the show, and a financing plan must allow for the satisfaction of varying investment vehicles.

Mixed-use projects that include housing contribute to a city's health, but are difficult to realize.

Of mixed-use projects, those urban infill developments in or near historic downtowns will be the most likely to be accepted by financial markets, despite their increased cost and complexity, because local governments are looking to improve their tax base and image, a larger inventory of comparables is available to financial analysts to determine the prospect of market success, and there are established, experienced urban developers that can bring such projects to completion.

Conventional development, however, still has a distinct competitive advantage over new mixed-use products—recent history. A wealth of information is available on the financial performance of the 19 standard product types, whereas only limited information is available on mixed-use developments, and even less information exists on their long-term performance. As a result, financing will be cheaper for the standard product types for the foreseeable future. But time will allow the mixed-use sector to have the same clout as conventional forms of development. As more and more mixed-use developments come to fruition, and as established mixed-use projects continue to perform, the information gap will shrink.

Demand for mixed-use projects exists in urban and suburban areas alike. Some consumer research has shown that one-third of the households in a number of metropolitan areas want a pedestrian-oriented, mixed-use development option. This amount of interest translates into significant pent-up demand. But for the mixed-use sector to succeed in the long term, financing practices must change in response to the provision of medium- and long-term returns, which in the case of mixed use are superior to the returns from conventional development. Further research is necessary to demonstrate the returns that medium- to long-term real estate investment can provide. ■

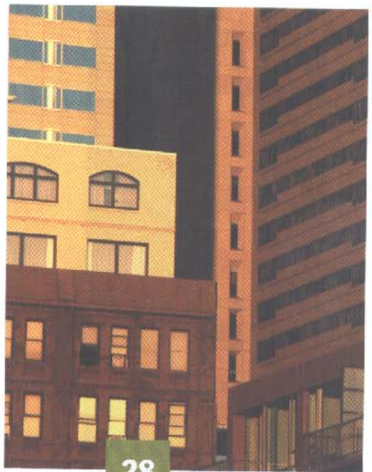
Christopher B. Leinberger is a partner in Arcadia Land Company, a new urbanism development firm, and managing partner in Robert Charles Lesser & Co., an independent real estate consulting firm. **Howard Kozloff**, a project manager at New York City–based BRV Corp., advises clients on urban redevelopment and public space improvement.


Multifamily TRENDS®
FALL 2003 ■ VOLUME 6, NUMBER 4
Site Specific
Reflecting on Landscape Design
Market Outlook 2004
Financing Mixed Use

Contents

Multifamily TRENDS

FALL 2003 ▪ VOLUME 6 ▪ NUMBER 4



28 Changing patterns.

Features

24 Awaiting the Job Recovery
ROGER PRATT
A return to job growth is essential for revived apartment demand.

28 Shifting Growth Patterns
G. RONALD WITTEN
Will tomorrow's demographics change the apartment business?

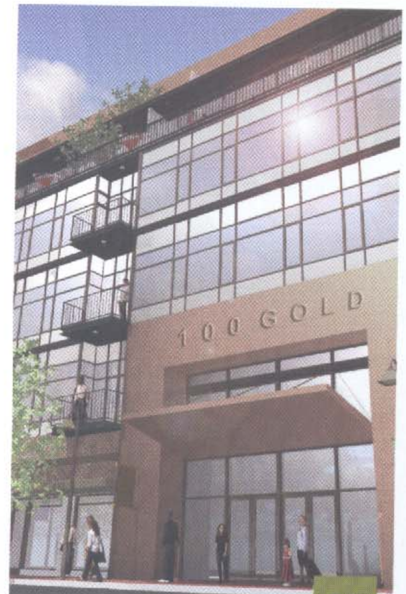
30 Portland on the Rise
BRAD BERTON
Developers set out to transform a former riverfront brownfield into Oregon's tallest and densest neighborhood.

36 Financing Mixed Use
CHRISTOPHER B. LEINBERGER AND HOWARD KOZLOFF
Rethinking conventional development forms could broaden investor focus and benefit the built environment.

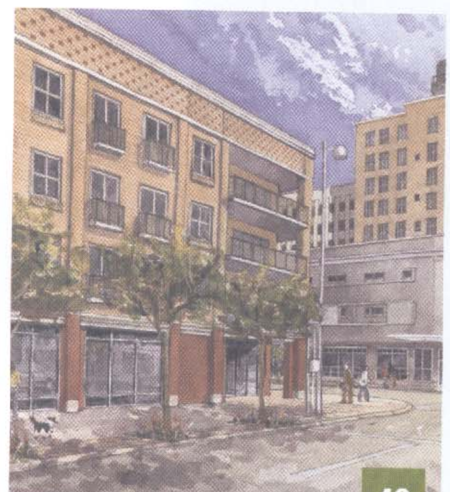
40 Converging Trends
RON HARWICK AND JOHN SCHRADER
The new urbanist communities are realizing development opportunities.

44 Life in a Western Resort Town
PETER BLAIS
Escalating land and construction costs in western resorts is pricing essential workers out of the housing market.

48 Multifamily's New Look
KATHY PRICE-ROBINSON
As urban dwellers spend more time at home and land prices remain at a premium, landscape architects work to enhance multifamily environs.



36 Finding financing.



40 Urban oasis.

ON THE COVER: Modern, glass-fronted apartments.

Photo: FI/Taxi/Getty Images

Departments

8 From ULI

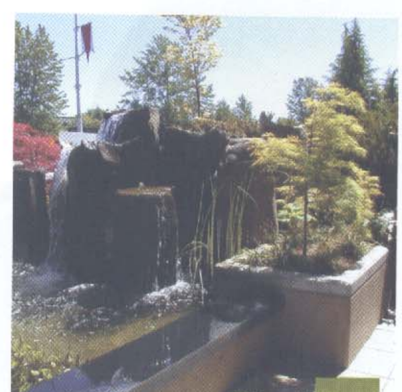
12 TrendWatch

20 Building Blocks

60 Inside ULI

63 Inside NAHB

Advertisers Index, page 55.



48 Environs to live by.