Changes in Real Estate Finance and Their Effect on Retail Development in Urban Areas

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Capital Markets and Inner City Retail Investment – Who’s Opportunity?

Overview:

- Changes in capital markets
- Where is the money going?
- Opportunities and challenges to inner urban development
- Public policy recommendations
Findings: Capital Markets
Sea Change in Real Estate Finance

- Equity: REITs are the largest institutional holders of real estate, increasing market share to 42.5% in 2002, from less than 3% in 1990. Opportunity Funds have also exploded in the 1990s to about half the size as REITs.

- Debt: Securitization has created significant new sources of debt for real estate development – Representing over half of new debt flow to commercial real estate.

- Much of the new capital is skipping over under-retailed urban markets.
Findings: Urban Retail Development

- Top tier markets are targeted for investment - both urban and suburban

- Risks, real and perceived, constrain active investment in tertiary urban markets

- Players in under-retailed urban markets include socially conscious funds, opportunity funds, national and local developers with high costs of capital, and some national retailers
Findings: Opportunities and Challenges

- Land availability and location, demographics, public infrastructure all very favorable...

- . . .however, soil contamination, land assembly, security costs, community resistance and plodding entitlement process require a rare level of patience (and patient money).
Findings: Policy Recommendations

- Federal, state, and local government policy must help to mitigate real and perceived risks of inner city urban development

- Government must take an active role in providing data and increasing market transparency, which would thereby remove some of the barriers to development and bridge the gap between real and perceived risks

- Tax incentives and public subsidies continue to be important in facilitating development, particularly in extremely distressed urban locations
Capital Sources: Total Debt at $1,133.4 Billion
- 1990 -

- Commercial Banks: $385.3B (34.0%)
- REITs: $7.3B (0.6%)
- Pension Funds: $36.2B (3.2%)
- Other: $14.2B (1.3%)
- Federally Funded Mortgage Pools: $29.5B (2.6%)
- Foreign Investors: $188.3B (16.6%)
- Savings Associations: $211.5B (18.7%)
- Life Insurance Companies: $255.3B (22.5%)
- Non-Government CMBS Issuers: $5.9B (0.5%)

Source: Rosen Consulting Group and Lend Lease Real Estate Investments
Capital Sources: Total Debt at $1,841.4 Billion
- 2002 -

Commercial Banks
$766.3B
42.0%

Non-Government CMBS Issuers
$307.5B
16.7%

Life Insurance Companies
$226.4B
12.3%

Foreign Investors
$213.6B
11.6%

Savings Associations
$142.0B
7.7%

REITs
$9.0B
0.5%

Pension Funds
$41.4B
2.2%

Federally Funded Mortgage Pools
$86.6B
4.7%

Other
$48.6B
2.6%

Source: Rosen Consulting Group and Lend Lease Real Estate Investments
Real Estate Capital Position: Debt

Source: Money Market Directory, National Association of Real Estate Investment Trusts, Federal Deposit Insurance Corporation, American Council of Life Insurers, Bureau of Economic Analysis, Federal Reserve, Lend Lease Real Estate Investments, Rosen Consulting Group
Flow of Funds to Commercial Mortgages from Commercial Banks

Source: Federal Reserve
Flow of Funds to Commercial Mortgages from Life Insurance Companies

Source: Federal Reserve
Domestic Commercial MBS: Gross Volume Issued

Source: Commercial Mortgage Alert, Rosen Consulting Group
Capital Sources: Total Equity at $211.3 Billion

- 1990 -

Pension Funds
$92.1B
43.6%

REITs
$5.6B
2.6%

Savings Associations
$20.5B
9.7%

Commercial Banks
$17.5B
8.3%

Foreign Investors
$34.9B
16.5%

Life Insurance Companies
$39.9B
18.9%

Source: Rosen Consulting Group and Lend Lease Real Estate Investments
Capital Sources: Total Equity at $474.2 Billion
- 2002 -

- Pension Funds $148.7B (31.4%)
- REITs $171.2B (36.1%)
- Foreign Investors $47.1B (9.9%)
- Life Insurance Companies $32.4B (6.8%)
- Commercial Banks $2.5B (0.5%)
- Savings Associations $0.9B (0.2%)
- Opportunity Funds $71.4B (15.1%)

Source: Rosen Consulting Group and Lend Lease Real Estate Investments
Real Estate Capital Position: Equity

Billion


Pension Funds  REITs  Commercial Banks  Life Insurance Companies  Foreign Investors

Source: Money Market Directory, National Association of Real Estate Investment Trusts, Federal Deposit Insurance Corporation, American Council of Life Insurers, Bureau of Economic Analysis, Federal Reserve, Lend Lease Real Estate Investments, Rosen Consulting Group
Market Capitalization of Equity REITs

Source: NAREIT, Rosen Consulting Group
Pension Fund 2001 Allocations*

* As of September 15
Source: Institutional Real Estate Letter, Institutional Real Estate, Inc.
Cumulative Equity Flows to Opportunity Funds

Source: Pension Consulting Alliance, Inc.
Investors driven by attractive Risk-Return Profile – Assets that will generate the highest possible return with the lowest level of risk on the risk-return frontier
Impact of Greater Securitization on Urban Retail Investment

- Lenders appear willing to finance urban retail projects, but report low activity in central cities. It is all about debt coverage and tenancy.

- CMBS loans are fairly diversified geographically, but loans tend to be placed in tertiary suburban markets rather than inner urban markets.

- Among untested markets, tertiary suburban markets pose less risk and barriers to entry compared with urban markets.
Impact of Greater Securitization on Urban Retail Investment

- Equity investors continue to target the top 15-20 markets in the country
  - High Household Incomes
  - Diverse and Stable Economies
  - Liquid Markets
## Retail REIT Holdings

### Top Ten Markets by REIT SF Exposure

<table>
<thead>
<tr>
<th>Metropolitan Markets</th>
<th>Total REIT Retail SF</th>
<th>% of REIT Assets in Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Houston, TX</td>
<td>18,738,610</td>
<td>3.3%</td>
</tr>
<tr>
<td>Atlanta, GA</td>
<td>17,075,690</td>
<td>3.0%</td>
</tr>
<tr>
<td>Chicago, IL</td>
<td>14,888,409</td>
<td>2.6%</td>
</tr>
<tr>
<td>Los Angeles-Long Beach, CA</td>
<td>13,351,077</td>
<td>2.4%</td>
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<tr>
<td>Philadelphia, PA-NJ</td>
<td>12,186,625</td>
<td>2.2%</td>
</tr>
<tr>
<td>Washington, D.C.-MD-VA-WV</td>
<td>11,965,566</td>
<td>2.1%</td>
</tr>
<tr>
<td>Dallas, TX</td>
<td>11,525,014</td>
<td>2.0%</td>
</tr>
<tr>
<td>Tampa-St. Petersburg, FL</td>
<td>11,099,669</td>
<td>2.0%</td>
</tr>
<tr>
<td>Boston-Brockton, MA</td>
<td>10,593,613</td>
<td>1.9%</td>
</tr>
<tr>
<td>Orlando, FL</td>
<td>8,650,682</td>
<td>1.5%</td>
</tr>
<tr>
<td><strong>Total Top Ten</strong></td>
<td><strong>130,074,956</strong></td>
<td><strong>23.0%</strong></td>
</tr>
</tbody>
</table>

### Top 25 Markets

<table>
<thead>
<tr>
<th>Top 25 Markets</th>
<th>Total REIT Retail SF</th>
<th>% of REIT Assets in Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>227,267,200</td>
<td>40.2%</td>
</tr>
</tbody>
</table>

Source: REIS; SNL Securities; Deutsche Bank Securities Inc. estimates and company information
Top Urban Retail Markets
“24-hour Cities”

- New York City
- Chicago
- Washington, DC
- San Francisco
- Boston

- Los Angeles Region – “18-hour City”
Super Stores’ Sales Cannibalization

Percentage of total warehouse club, super store, department store, Internet and catalog sales

Sources: US Census Bureau
Defining the Opportunity

- Central locations
- Underutilized infrastructure
- Lack of competition
- Supply constraints
- High population density
- Strong growth of immigrant populations
U.S. Immigration by Decade

Source: Department of Commerce, US Census Bureau

Source: US Census Bureau
Percent of Population Residing in Central Cities

- Non-Hispanic White: 21%
- Asian/Pacific Islander: 41%
- Hispanic: 46%
- Black: 52%

Source: US Census Bureau
Barriers to Urban Retail Investing

- Real and perceived risks
- Security and “shrinkage”
- Building costs
- Entitlements and approval process
- Land assembly
- Political and community resistance
- Environmental remediation costs
- Securing retail tenants
Some Successes

- Profit-Driven Opportunity Investors
- Socially Conscious Investors and Funds
- National Retailers
The Right Ingredients for Successful Urban Development

- Tax incentives/subsidies
- Patient money
- Successful track record of public/private partnerships
- High population density and buying power
- Proximity to a diverse economy
- Underutilized infrastructure and central location
- “Fast track” entitlement process
- Assistance with land assembly
- Interested retail tenants
Conclusions

- Mixed implications for inner city retail development

- With the securitization of the industry, there is more potential to do riskier projects in different areas

- However, capital is still resistant to economically disadvantaged areas. Tenancy and sponsorship are key

- Extremely distressed urban areas may be left out without large subsidies
What Can Public Policy Do?

- In order to attract retail development to central cities, policies must focus on mitigating risk.
Policy Recommendations

- **Reducing Real and Perceived Risks**
  - Providing more public information/resources to private sector -- Examples include land parcel database, demographic databases to determine demand conditions, and crime cost information
  - Government Involvement -- Assist with land assembly, provide fast-track approval, shore up community support, and mitigate liability risk of contaminated land

- **Improving Returns**
  - Continue to provide public subsidies to retailers and financiers to mitigate high building costs and security and theft issues
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