SHOPPING THE CITY: REAL ESTATE FINANCE AND URBAN RETAIL DEVELOPMENT

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EXECUTIVE SUMMARY

Despite the increase in real estate financing instruments over the past decade, inner city retail development has lagged in all but a select few cities. Indeed, even though new methods of financing have led to more liquid markets with potentially a broader appetite for risk, developers and their financial backers have continued to pursue projects primarily in top-tier cities and suburbs.

To look more closely at retail investment in distressed urban areas, this paper examines the major changes in the real estate finance marketplace, the implications of those changes on development decisions, and public policy actions that could facilitate projects in these markets.

Overall the paper finds that:

- **Out of the ashes of the real estate recession of the early 1990s three major real estate financing vehicles—Real Estate Investment Trusts, Commercial Mortgage Backed Securities, and Real Estate Opportunity Funds—emerged.** REITs are now the largest holders of institutional real estate, surpassing life insurance and pension funds.

- **However, despite the robust economy of the 1990s, greater securitization has not led to major shifts in retail development patterns.** Instead, REITs are primarily focusing their efforts on the largest investment-grade markets with proven track records. For investors searching for greater returns, along with the attendant risk, small suburban markets have been attractive, not inner city locations. The urban development that has taken place occurred in a select few cities with thriving downtowns.

- **Public policy can bolster the prospects for underserved urban markets. However, rather than focusing solely on subsidies, which can lead to unsuccessful (e.g. vacant) projects, the public sector should examine strategies that mitigate risk and improve returns.** This includes improving the availability of information about these markets with tools like property databases, improved demographics, and crime statistics. Also, government guarantees on permit speed and environmental conditions can also greatly reduce risk.

Though the seismic changes in real estate finance has not led to a torrent of investment in inner urban areas, they do increase opportunities for those types of projects, albeit with proper government support. Moreover, often these areas are under-retailed and have significant pent up demand for services other areas take for granted. Also, frequently the complexities and densities of urban neighborhoods preclude other competitive projects, offering additional reward for real estate investors and retailers.

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SHOPPING THE CITY:
REAL ESTATE FINANCE AND URBAN RETAIL DEVELOPMENT

~~I.~~I. INTRODUCTION

Except for a handful of 24-hour cities with high incomes, and perhaps a few major tourist destinations, many urban areas across the United States are under-retailed. However, a confluence of factors has contributed in recent years to the revitalization and development of what investors call first- and second-tier urban and inner-suburban areas.[1] Changing demographic trends are a major driver attracting investors and developers to these markets. Young professionals and empty nesters are moving to the downtown and represent a significant source of buying power. In addition, the strong growth of immigrant populations in inner cities and urban neighborhoods represents untapped consumer markets with significant growth potential

Retailers are also beginning to realize that underserved areas have similar income demographics with the benefits of higher population density. In fact, studies demonstrate the unmet demand potential in many urban neighborhoods. According to the Initiative for a Competitive Inner City (ICIC), inner-city America spends about $85 billion on retail goods and services every year, representing approximately 7 percent of total U.S. spending power. They note that about one-fourth of inner-city retail demand is not being met by retailers. With their dense populations, inner-city areas often have demand between two and six times that of their metropolitan area average.[2]

In addition to compelling demographic trends, cities have several physical characteristics that are appealing to investors and retail tenants. Urban areas are often centrally located, have underutilized infrastructure, and have available sites in areas with identity and visibility. Additionally, unlike many suburban locations, supply constraints in urban neighborhoods and other barriers to entry limit future competition. Inner-city locations are perhaps the “last frontier” for retail development. According to the National Research Bureau, the amount of gross leaseable mall area has mushroomed from 7.3 feet per capita in 1970 to 20.0 feet per capita in 2001.[3] The vast majority of this new development has occurred in higher-income suburban markets, resulting in fierce competition in these areas.

Finally, changing retail formats have made underserved urban areas more attractive to retailers. In the face of increased competition, retailers have added concepts aimed at serving niche markets in different income and demographic sectors. Big box retailers such as Wal-Mart, Target, and K-Mart are increasingly targeting inner-city locations, and niche retailers such as Home Depot have opened stores in urban areas. Sam Walton, the founder of Wal-Mart, is famous for recognizing the retail potential in underserved, low-density and low-income rural areas where land and buildings

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[1] First and second tier markets are characterized by strong income growth, a diverse economy, and supply constraints, which limits the chances for overbuilding in the market.
[2] Institute for a Competitive Inner City, “ICIC Research Facts” (2003).
[3] National Research Bureau, “Shopping Center Census” (2002).

costs are relatively inexpensive. The company recently announced plans to debut an urban store format in Dallas with two stories to accommodate their large format.

While these factors are compelling, to better understand the true potential of inner-city areas to attract retail development it is essential to examine how real estate projects acquire the capital needed to finance them. During the past decade, for example, the equity and debt markets have been significantly transformed, creating new sources of financing and making real estate investments available to a broader segment of the investment market. Using available data and drawing from selected interviews with real estate industry participants, this paper seeks to answer the question of whether these changes have had a measurable influence in on real estate investing across geography, particularly as it applies to retail development in distressed areas. The paper is divided into three sections. The first section discusses major changes in the capital markets during the past decade, both on the equity side and debt side. The second section examines the implications of these changes on real estate investment and development decisions. Finally, the paper concludes with public policy recommendations that may help to facilitate real estate investment in underserved urban markets.

II. THE TRANSFORMATION OF REAL ESTATE EQUITY AND DEBT MARKETS

Greater securitization has changed the commercial real estate investment landscape during the last decade. The rise of public markets after the real estate recession in the early 1990s has created new sources of financing and increased transparency in the market, providing more opportunities for higher risk projects, which institutional investors would have avoided in the past, to be funded. These new sources of capital—Real Estate Opportunity Funds (REOFs), Real Estate Investment Trusts (REITS), and Commercial Mortgage Backed Securities (CMBS)—have also changed the role of traditional investors. On the equity side, public sources of financing have surpassed pension funds and life insurance companies. On the debt side, the role of traditional players has increasingly become that of mortgage originators rather than long-term holders of commercial mortgages.

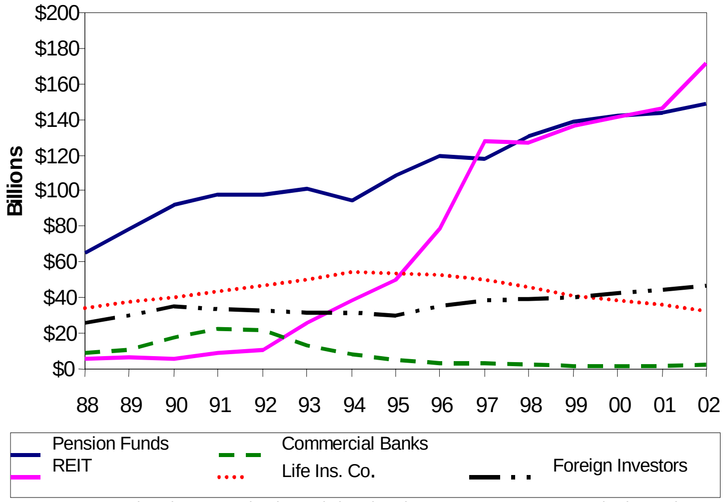
A. Real Estate Equity

The 1990s saw a remarkable transformation of real estate capital markets due to the emergence of REITs and REOFs. Out of the distress of the real estate depression of the early 1990s, REITs and REOFs arose to re-capitalize and restructure the real estate equity markets, controlling far greater equity than in the past. Pension funds also continue to be a major source of real estate financing.

1. The Biggest Kid on the Block: Real Estate Investment Trusts (REITs)

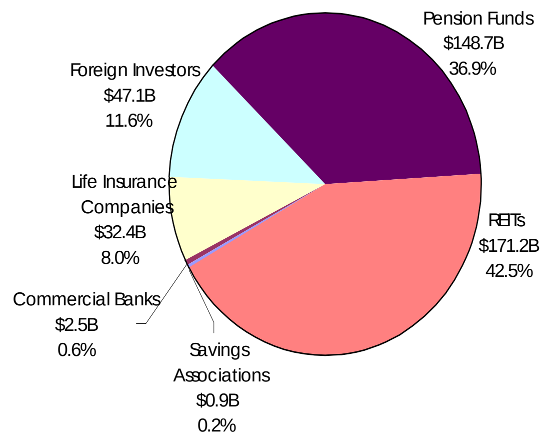
Congress created REITs in 1960 to provide small investors with opportunities to invest in large commercial real estate projects. But because REITs were prohibited from managing and operating properties until 1986, they comprised only a small segment of the market. Additionally, tax laws during this period favored private real estate ownership. These laws allowed private owners to shelter real estate and other income from tax, a benefit not provided to shareholders of REITs. The 1986 Tax Reform Act restructured depreciation schedules and limited interest deductions for private real estate, making these investments less likely to act as a tax shelter for investors. Additionally, REITs were permitted to operate and manage property, giving them more control over their investments.

Figure 1. Real Estate Capital Position: Equity



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

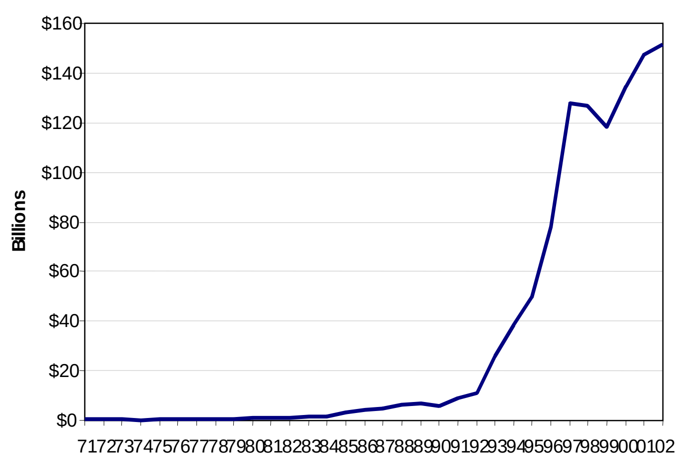
Figure 2. Institutional Capital Sources: Total Equity at $402.8 Billion



Source: Rosen Consulting Group and Lend Lease Real Estate Investments

Despite these changes, REIT investment did not increase dramatically until the 1990s, when the credit crunch made it difficult for investors to raise private equity. As private equity became scarce, real estate companies reached out to public market for capital. By 2002, REITs were the largest holders of institutional real estate, accounting for 42.5 percent of total equity holdings nationally, or $171.2 billion, up from $6 billion in 1990.[4] Between 1990 and 2002 equity REIT market capitalization increased from $5.6 billion to $151.3 billion, its highest level in history (Figure 3).[5]

Figure 3. Market Capitalization of Equity



Source: NAREIT, Rosen Consulting Group

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[4] Jonathon D. Miller, *Emerging Trends in Real Estate 2003* (New York: Lend Lease Real Estate Investments and PricewaterhouseCoopers LLP, 2002).

[5] National Association of Real Estate Investment Trusts, "Market Capitalization of Equity REITs," available at www.nareit.com/researchandstatistics/marketcap.cfm (March 2003).

The growth of REITs has been beneficial for the market for several reasons. First, through the securitization of real estate assets, REITs provide an investment vehicle for a broader spectrum of institutional and individual investors. Second, REITs benefit from scale and expertise, management advantages, and their ability to add value on the asset level. Real estate in general has also benefited from improvements in real estate information and research services, partly the result of the increased transparency required of REITs. There is a better understanding about investment fundamentals in both the operating market and capital market that determine values and risk.

2. Pension Funds Continue to Be A Major Source of Financing

Pension funds' equity assets in real estate have doubled in the past decade, from $92.1 billion in 1990 to nearly $150 billion in 2002 (Figure 1).[6] Today, these funds are the second largest holders of institutional real estate after REITS, with $148.7 billion (36.9 percent), in real estate holdings in 2002 (Figure 2). Most pension funds aim to invest 8 percent to 10 percent of their total assets in real estate. The booming real estate markets of the mid- to late-1990s created strong incentive for pension funds to step up their real estate allocations and investments. Pension funds' real estate allocations continued to increase during 2001 and 2002 as the stock market declined.

As long-term holders of real estate (typically 7 to 10 years or longer), pension funds have less risk tolerance and have historically focused on acquiring core, stable-income properties. While pension funds have traditionally been focused in private equity investments, they are increasingly looking towards other areas of real estate investing such as public equity (REITs), private debt (commercial mortgages and whole loans), and public debt (CMBS). It is estimated, for example, that about 20 percent to 25 percent of pension funds' real estate portfolios are invested in REIT stocks, which have greater liquidity and fewer hassles than direct investments. As a result of these shifts, the new dollar flow to direct real estate investment has slowed in the 1990s.

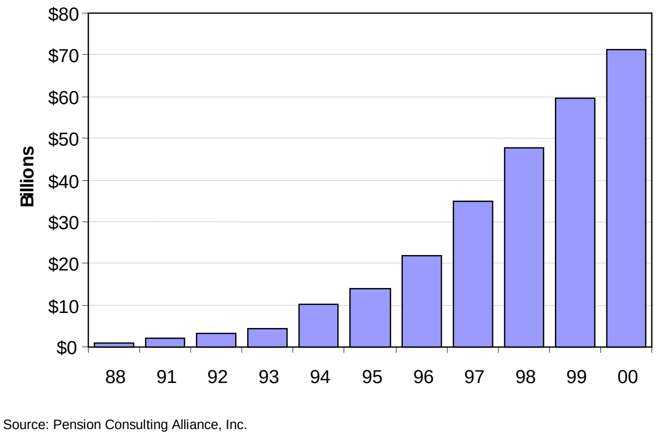
3. In Search of Higher Returns: The Real Estate Opportunity Fund Vehicle

The real estate opportunity fund vehicle was first established in the early 1990s to take advantage of the distress and the subsequent restructuring opportunities that were available following the recession. Banks, Savings and Loans (S&Ls), insurance companies, and other real estate investors and companies had all contributed to the massive overbuilding and over-leverage that engulfed the real estate market in the late 1980s. As the government took over a large number of failed financial institutions and sold off their assets through the Resolution Trust Corporation (RTC), the "opportunity" became apparent to private capital market investors. Investment banks and private capital market investors were the first to recognize this opening in the investment market and

[6] Miller, *Emerging Trends in Real Estate 2003.*

set up “opportunity funds.” As a result, they were established as investment partnerships modeled on the private equity model rather than the traditional real estate pension advisory model.[7]

Figure 4. Cumulative Equity Flows to Opportunity Funds



Various types of REOFs exist today, including funds that were sponsored by investment banks to take advantage of the RTC activities, and others that emerged from the private equity business, traditional real estate pension advisors, real estate operating companies, and various other players in the real estate industry. Investment banks, boutique firms, private equity shops, traditional advisors, and real estate operators have all participated extensively in REOFs.

Real estate opportunity funds today control more than $70 billion of equity real estate. Figure 4 displays the cumulative committed equity in opportunity funds by year as calculated by a Pension Consulting Alliance, Inc. (PCA) study, the most comprehensive study of the opportunity fund industry to date.[8]

Opportunity fund returns have historically substantially exceeded those of core investments and REITs. The emergence of real estate opportunity funds has created an investment vehicle that matches the risk and return preferences of investors with investment opportunities, expanding the availability of financing for high-risk distressed properties. The large number of troubled properties in the early- to mid-1990s enabled opportunity funds to purchase assets at 50 cents on the dollar. The market environment turned highly competitive during the late 1990s, however, and it became more difficult to find opportunistic deals. Though investors expected to find distressed opportunities in the current market downturn, low interest rates have enabled many troubled owners to hold onto their properties by refinancing debt. As a result, it has been difficult for investors to find opportunistic investments in recent years.

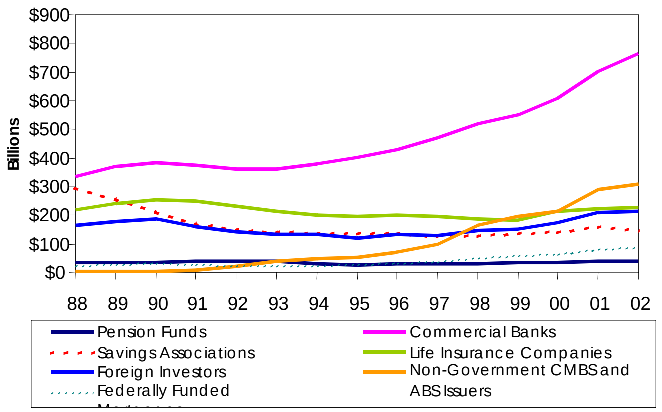
[7] In general, the private equity model is based on co-investing and performance-based compensation, and involves a more aggressive, higher-risk investment approach when compared with the pension advisory model, which has traditionally been based solely on asset management fees of stable properties.
[8] Pension Consulting Alliance, "Real Estate Opportunity Funds: The Numbers Behind the Story" 2002.

The typical real estate opportunity fund is structured as a limited partnership with a five-to-seven year life span. The sponsor, as general partner, contributes 5 percent to 25 percent of the equity, and the limited partners, typically pension funds, endowments, and wealthy individuals, contribute the remainder of the capital. The returns to the limited partners are usually marketed as being in the 20 percent-plus range, though in the current market downturn, funds are shifting their strategies to investments that carry less risk and have lower returns. According to a survey by Real Estate Alert, only 21 percent of new funds seeking returns of 12 percent or more are targeting investments with 20 percent or higher yields, down from 45 percent a year ago.[9]

B. Real Estate Debt

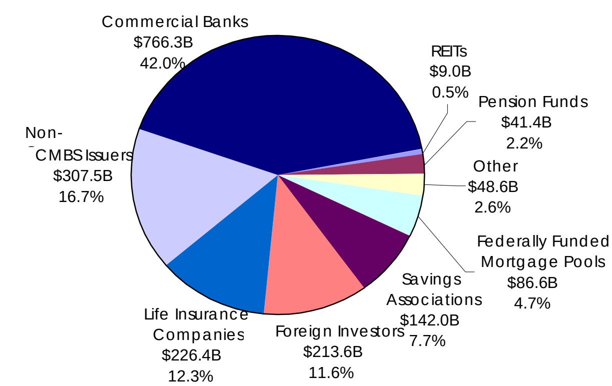
Capital sources for commercial mortgages have also changed dramatically during the past decade. The relative role of traditionally large suppliers of debt capital has diminished (S&Ls) or evolved (commercial banks and life insurance companies) and new investment sources have emerged. Most significantly, the Commercial Mortgaged Backed Security was developed, allowing investors to match debt purchases with their risk-return preferences, and radically transforming the market.

Figure 5. Real Estate Capital Position: Debt



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

Figure 6. Institutional Capital Sources: Total Debt at $1,841.4 Billion



Source: Rosen Consulting Group and Lend Lease Real Estate Investments

[9] "Fund Operators Lower Yield Expectations," *Real Estate Alert*, February 26, 2003.

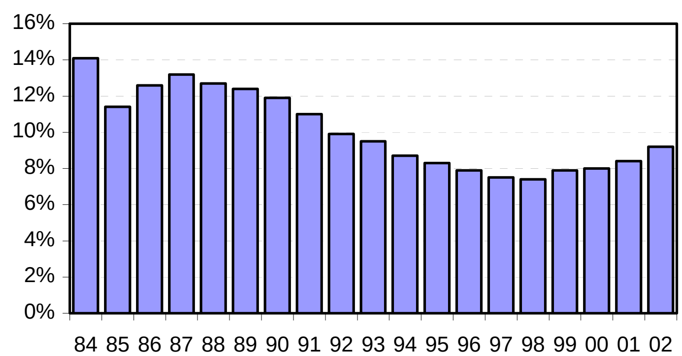
Although several factors brought about these changes, the event that had the most dramatic affect on commercial mortgage composition was the savings & loan crisis of the late 1980s and early 1990s, coupled with the real estate market collapse and resulting mortgage delinquencies and credit crunch. The Resolution Trust Corporation (RTC) took over the assets of failing thrifts, pooled their assets, and securitized the mortgage paper, creating the beginnings of the CMBS market.

1. The Changing Role of Traditional Sources of Capital

a. Savings and Loan Institutions (Thrifts)

Perhaps the biggest transformation has been for Savings & Loans whose role in the financing of commercial real estate has diminished considerably. Deregulation in the early 1980s changed the scope of the S&L industry by allowing nonresidential commercial lending and then loosening underwriting standards and allowing much riskier, much larger scale loans than had not been permitted before. After the savings and loans crisis, the FDIC took note and started imposing stricter underwriting standards. These changes dried up capital not only for speculative suburban office buildings; they also drastically cut the funds available for urban development. Between 1988 and 2000, the value of nonresidential loans by FDIC-insured savings institutions decreased by more than 30 percent. Non-residential real estate loans dropped from 14 percent of savings institution lending to only 8 percent, though total real estate lending levels were comparable (Figure 7).[10]

Figure 7. Savings and Loan Institutions: Percentage of Real Estate Loan Portfolios in Commercial Loans



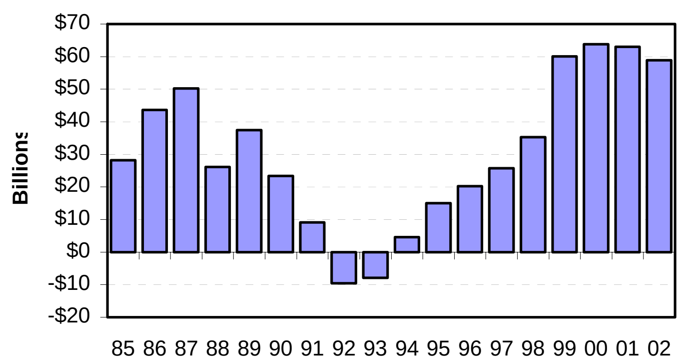
Source: FDIC

[10] Federal Reserve, "Flow of Funds Accounts of the United States" (Board of Governors of the Federal Reserve System).

b. Commercial Banks

Commercial banks are the dominant providers of funds to the commercial real estate market. In 2002, they held $766.3 billion in mortgages, accounting for 42 percent of total outstanding debt in the United States.[11] Flow of funds to mortgages has ranged between $60 billion and $65 billion annually during the past four years (Figure 8).[12] Commercial banks' loan terms have changed in the last decade, contributing to the shifts in commercial mortgage lending. Most bank loans do not provide long-term fixed-rate mortgages; instead most offer floating rate mortgages for loans with two- to five-year terms. This transformation in mortgage structure took place because the terms of bank's liabilities have shortened. Bank customers are increasingly opting for short-term money market accounts, rather than longer-term certificates of deposit. To match the maturity on assets and liabilities, banks have altered their lending practices on the asset side of their balance sheet. With fewer fixed-rate mortgages available from commercial banks, the role of CMBS has expanded as these securities provide a source for fixed-interest rate lending.

Figure 8. Flow of Funds to Commercial Mortgages from Commercial Banks



Source: Federal Reserve

In addition to offering traditional portfolio lending, commercial banks are also increasingly becoming originators for loans that are securitized and sold as CMBS. The market for these securities has allowed banks to increase both their lending volume and the range of debtors to whom they can extend mortgage debt. Commercial banks are able to capitalize on their existing lending infrastructure and collect origination fees and ongoing servicing fees while avoiding risk-based capital costs, provided the mortgages are bundled and sold as CMBS. Commercial banks not only pool and warehouse loans as conduits do, but they also originate mortgages. Commercial banks' ability to act as both originator and conduit give these institutions an advantage over other providers of debt financing.

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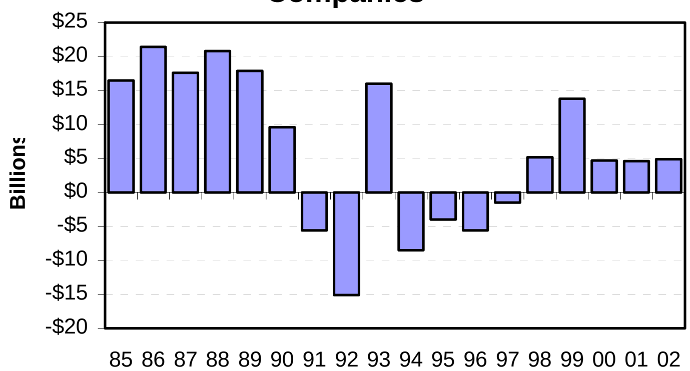
[11] Miller, *Emerging Trends in Real Estate 2003.*
[12] Federal Reserve, "Flow of Funds Accounts of the United States."

c. Life Insurance Companies

During the 1990s, a decrease in demand for long-term, or whole life, insurance policies caused insurance companies to scale back their demand for long-term investments, particularly for commercial mortgages. In an effort to match the terms on their liabilities (insurance policies) to their assets (investments), insurance companies have also shifted from direct investment in commercial mortgages to investment in the more liquid CMBS market. Investment in mortgages by life insurance companies fell 93 percent from $16.5 billion in 1985 to $1.2 billion in 2002 (Figure 9).[13] Total debt holdings in 2002 were $226 billion, accounting for 12.3 percent of total outstanding debt.[14]

Figure 9. Flow of Funds to Commercial Mortgages from Life Insurance Companies



Source: Federal Reserve

2. The Rise of the CMBS Market

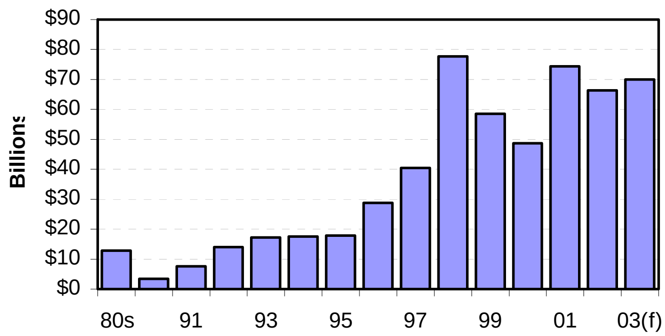
Commercial Mortgaged Backed Securities accounted for $307 billion, or 16.7 percent, of total outstanding debt in 2002.[15] The development of CMBS was an important advancement in the real estate debt market because it opened the door for investors who previously would not have directly invested in commercial mortgages. Using the CMBS vehicle, institutional investors such as mutual funds and pension funds may finance mortgage debt. Additionally, CMBS has broadened the resources dedicated to commercial mortgage lending by using Wall Street infrastructure. Mortgage originators can replenish their lending resources through the sale of mortgages to the secondary market. Once these CMBS securities are sold, issuers are paid-off and the investor in the securities is the ultimate source of funding for the mortgage pool.

[13] Ibid.
[14] Miller, *Emerging Trends in Real Estate 2003.*
[15] Ibid.

CMBS are multi-tiered structures differentiated by risk profile, allowing for a more diverse array of investment and financing opportunities. CMBS allows lesser credit borrowers access to the market, as the terms of the loan are structured to offset various underwriting risks. Building owners can obtain financing for properties with a higher risk profile, which may not have occurred before securitization became widely used. The CMBS vehicle better matches investors and their risk profile to investments, creating a more fluid market with broader investor participation.

Securitization increased dramatically during the 1990s. The gross amount of CMBS issued annually rose to $66 billion in 2002 from $3.4 billion in 1990. For the entire decade of the 1990s, CMBS volume totaled approximately $330 billion, compared with about $13 billion in the 1980s. Annual volume has fluctuated between $50 billion and $80 billion during the past five years in response to mortgage origination volume and investor demand (Figure 10).[16]

Figure 10. Domestic Commercial MBS: Gross Volume Issued



Source: Commercial Mortgage Alert, Rosen Consulting

[16] Domestic Commercial MBS: Gross Volume Issued, *Commercial Mortgage Alert.*

III. IMPACT OF GREATER SECURITIZATION ON URBAN RETAIL INVESTMENT

While greater securitization in the equity and debt markets has increased liquidity and opened up new sources of financing for non investment-grade development, in practice this trend has not translated into more money flowing to urban areas, or more specifically, to retail projects in distressed urban areas. Instead, investors continue to target their dollars toward economically strong urban and suburban markets with proven track records. This is generally due to the fact that investment in many inner-city markets poses major barriers to entry, and risk-adjusted returns have been insufficiently attractive to draw capital. In the current economic environment, tolerance for risk is especially low. Though examples of successful urban retail projects exist, it is evident that the perceived risks involved for most investors outweigh the rewards.

A. Investors Prefer Top-Tier Markets

Although most industry participants acknowledge that investment opportunities are not limited exclusively to top-tier markets, equity investors continue to have a strong preference for larger markets for all types of commercial real estate. Pension fund managers, for example, prefer properties located in the nation's 20 largest metropolitan areas, according to Mike Acton, director of research at AEW Capital Management.[17] Larger cities are perceived to be stronger than smaller markets because they have more diverse and stable economies.

New sources of capital in the public market, namely REITs, have also not ventured into non-traditional areas for the most part, and their holdings tend to be geographically concentrated in the top markets. A recent study of REIT holdings at the end of 2001 illustrates this point. The study shows that industrial REITs have their holdings concentrated in about 20 markets, with the top five markets representing 36 percent of the holdings, as shown in Table 1. Office and apartment REITs also have concentrated holdings, with specific cities making up more than 10 percent of their portfolios. Retail REITs are the most diversified of the commercial real estate properties, with the top five markets comprising just 13.5 percent of the total holdings.[18]

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[17] Matt Valley, "Pension Fund Money is Coming Back," *National Real Estate Investor*, April 1, 2002.

[18] Louis W. Taylor and others, "Geographic Compilation: Markets That Matter Most to REITs," North America Equity Research, Deutsche Bank Securities, Inc., May 2002.

Table 1. Top 5 Metropolitan Markets in Each Property Type

Property Type/Metropolitan Markets	Total REIT in SF or Units	Assets in Markets
Apartments (Units)		
Atlanta	60,731	7.2%
DC Metro	60,202	7.1%
Dallas	59,912	7.1%
Houston	44,000	5.2%
Los Angeles/Orange County	39,874	4.7%
Subtotal	**264,719**	**31.3%**
Office (SF)		
New York	51,332,171	9.7%
DC Metro	44,739,285	8.5%
Chicago	31,605,934	6.0%
Atlanta	27,611,753	5.2%
Dallas	25,747,359	4.9%
Subtotal	**181,036,502**	**34.4%**
Retail (SF)		
Houston	18,738,610	3.3%
Atlanta	17,075,690	3.0%
Chicago	14,888,409	2.6%
Los Angeles/Long Beach	13,351,077	2.4%
Philadelphia	12,186,625	2.2%
Subtotal	**76,240,412**	**13.5%**
Industrial (SF)		
Chicago	48,964,881	11.6%
Atlanta	33,520,607	7.9%
Indianapolis	27,638,790	6.5%
Dallas/Fort Worth	23,892,730	5.6%
Minneapolis	19,236,154	4.5%
Subtotal	**153,253,162**	**36.2%**

Source: REIS; SNL Securities; Deutsche Bank Securities Inc; estimates and company information

Though retail property ownership among REITs is more geographically dispersed compared with other property types, it is still evident that investor interest is focused on the larger markets. A sampling of REIT data shown in Table 2 illustrates this point. The table, which lists the top 10 markets where REITs owned retail property at the end of 2001, shows that nearly one-quarter of REITs' retail assets are focused in ten major metropolitan markets across the country.[19] Most of these markets have large suburban areas, where most of the retail development is taking place.

[19] Ibid.

Conversations with pension funds and other real estate investors supported this preference for top suburban markets.

Table 2. Top Ten Markets by REIT SF Exposure

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

Source: REIS; SNL Securities; Deutsche Bank Securities Inc; estimates and company information

To the extent that urban areas are receiving capital flows for retail development, attention is focused on a top handful of markets. Urban areas that have 24-hour activity levels, cities with active central businesses districts and associated daytime population, and/or major tourist destinations are garnering the dominant share of interest and investment activity. Compelling demographic trends, high barriers to entry, and the identity and visibility of these thriving downtown districts have encouraged developers such as Federal Realty, Forest City, Millennium, TrizecHahn, and MacFarlane Partners to build successful urban retail and mixed-use projects across the country.

In a survey of major institutional investors (Emerging Trends in Real Estate 2002), the top five urban markets—New York, Washington D.C., Boston, Chicago, and San Francisco—are identified as 24-hour cities, that is, urban areas that consistently draw the lion's share of institutional investor interest. Emerging Trends also identifies the clusters of suburbs stretching from San Diego to north of Los Angeles as a sixth major market. The southern California markets, along with the five 24-hour cities, are together dubbed the "Consensus Six," in reference to their popularity with investors. The publication also notes, "Beyond these markets, interest among the Emerging Trends experts drops off noticeably." Interviewees noted the long-term investment potential of mixed-use, dense areas, particularly the strength of this type of investment during downturns in the real estate cycle.[20]

Real estate opportunity funds generally go after the same urban and suburban markets that REITs and pension funds target, but will look for buildings with "flaws" that can be remedied, such as low occupancy. These funds typically seek out institutional quality assets that are priced well below

[20] Jonathon D. Miller, Emerging Trends in Real Estate 2002 (New York: Lend Lease Real Estate Investments and PricewaterhouseCoopers LLP, 2001).

replacement cost. After acquiring the property, opportunity funds will lease it up, renovate the property, or make other improvements, then either resell or refinance it. Once the building is brought up to market value, REITs or pension funds could be potential buyers. While opportunity funds may be more willing to look at projects in untested markets, such as inner cities, these funds may be more likely to venture into tertiary suburban markets, which pose less risk and barriers to entry compared with distressed urban markets.[21]

While concrete data is difficult to obtain, interviews with lenders indicate that CMBS has a more geographically diversified investment profile than the REIT market, but loans in untested areas in most CMBS portfolios are in tertiary suburban markets. Local or regional developers rather than institutional investors are the primary borrowers of these tertiary market loans. A recent survey of top loans made by major lenders for retail projects reveals this trend. Table 3 shows that loans were made in a variety of markets in top-tier investment grade areas such as Houston and Los Angeles, but many of the largest loans were for projects in smaller metropolitan areas.[22]

[21] Tertiary markets are characterized by a smaller population base and less diverse economies when compared with first tier and second tier (or primary and secondary) markets.

[22] Brandon Boswell, "Retail Projects Continue to Shake the Money Tree in 2000," *Shopping Center World*, April 1, 2000.

Table 3. Retail Project Lenders' Major Projects 1999

LENDER	Center Name	City	Loan Amount
LEHMAN BROTHERS	Ala Moona Center	Honolulu, HI	438,000,000
	Century City Mall	Los Angeles, CA	160,000,000
	Woodland Hills Mall	Tulsa, OK	90,000,000
	Sangertown Square Mall	New Hartford, NY	76,500,000
GMAC Commercial Mortgage	Red Rose Commons	Lancaster, PA	28,300,000
	Hampshire Mall	Hadley, MA	24,500,000
	Safeway Plaza	Maple Valley, WA	12,000,000
	47-71 Tamal Vista Blvd	Carte Madera, CA	6,000,000
TIAA-CREF	Parks at Arlington	Arlington, TX	115,000,000
	Citrus Park Town Center	Tampa, FL	100,000,000
	Southcenter Mall	Tukwila, WA	95,000,000
	Baybrook Mall	Houston, TX	95,000,000
	Coastland Center	Naples, FL	87,000,000
Morgan Stanley/Dean Witter	Houston Galleria	Houston, TX	225,000,000
	Mall of New Hampshire	Manchester, NH	115,000,000
	Santa Monica Place	Santa Monica, CA	90,000,000
Keybank National Association	Northeast Mall	Hurst, TX	156,000,000
	Sammamish Center	Issaquah, WA	36,920,000
	Troy Marketplace	Troy, MI	31,355,000
CIBC World Markets	Ala Moana Center	Honolulu, HI	325,000,000
	Wesfield Shopping Town/ Valley Fair	San Jose, CA	275,000,000
	Summit Square	Warwick, RI	12,300,000
First Union Securities	Mall of America	Bloomington, MN	156,000,000
	Washingtonian II	Gaithersburg, MD	39,500,000
	Albany Mall	Albany, GA	31,600,000
	Warner Marketplace	Canoga Park, CA	28,000,000
	Hawthorne Works	Cicero, IL	24,802,000
Deutsche Bank	Hampshire Mall	Hadley, MA	24,500,000
	Centereach Mall	Centereach, NY	23,300,000
	Fairgrounds Square Mall	Muhlenberg	21,800,000
	Middletown Mall	Fairmont, WV	13,500,000
	Imperial Plaza and Mall	Wappinger Falls, NY	11,700,000
	Woodberry Shopping Center	Hicksville, NY	7,000,000
Chase Manhattan Bank	Mall of America	Bloomington, MN	312,000,000
	Rego Park Plaza	Rego Park, NY	82,000,000
	Auburn Mall	Auburn, MA	48,000,000
	Greendale Mall	Worchester, MA	42,000,000
	Apple Blossom Mall	Winchester, MA	41,000,000
JP Morgan Mortgage Capital	Arvadal Marketplace	Arvada, CO	33,150,000
	Frederick Towne Mall	Frederick, MD	24,795,000
	Penn Mar Shopping Center	Forestville, MD	22,325,000
Bear, Stearns & CO	Plymouth Square Shopping Center	Plymouth Meeting, PA	15,300,000
	Albertson's Marketplace	Long Beach, CA	8,700,000
	205 Place Shopping Center	Portland, OR	7,850,000
	Wild Oats Marketplace	Las Vegas, NV	7,250,000
American Commercial Capital	Town & Country	San Angelo, TX	112,000,000
	Tacala	Birmingham, AL	59,000,000
	Kwik King	Ocda, FL	38,000,000
	Sailorman	Miami, FL	35,000,000
	21st Century	San Diego, CA	11,000,000
Washington Capital Management	Gardena Valley Plaza	Gardena, CA	20,000,000
	Studio City Plaza	Studio City, CA	20,000,000
	Gateway at Burbank	Burbank, CA	16,750,000
	Ranch Bernardo Village	San Diego, CA	10,000,000
	Lakewood Plaza	Lakewood, CA	6,000,000

Source: Brandon Boswell, "Retail Projects Continue to Shake the Money Tree in 2000," *Shopping Center World*, April 1, 2000.

B. Barriers to Urban Retail Development Are Often High

One of the largest deterrents to inner-city development—and hence the greater preference for developing in tried and true locations—are the real and perceived barriers to developing in these markets. Urban projects often face political and community resistance, and obtaining city approvals and entitlements can sometimes take 10 or more years. Urban locations are also more complex to build in. It is often difficult to find land and assemble parcels in urban locations. Parcels in the inner cities are often small, requiring the developer to assemble several parcels. Also, sites may be contaminated and require environmental remediation, further adding to development costs. Additionally, building costs are often high because urban retail and mixed-use projects are more difficult than construction of typical suburban projects. The site area tends to be tight and confined, and because architects must design for specific site needs, construction tends to be more complex, and accommodating parking is more difficult and costly. Urban areas also require attention to other issues such as security/surveillance systems, security personnel, adequate lighting, etc. that may add to the cost of a project.

Table 4. Barriers to Urban Retail Investing

Barriers to Urban Retail Investing	Potential Public Policy Solutions	Type of Intervention
Political and Community Resistance	Shoring up community support	Direct Action
Drawn-out city approval process and entitlement complicators	Fast-Track Approval Process	Direct Action
Difficulty in assembling land because of smaller parcel size	Land Parcel Database	Information Dissemination
Environmental remediation costs	Provide 'dean" land, Mitigate Liability Risk	Direct Action
High building costs	Subsidies	Monetary Incentive
Difficulty in securing creity-worthy national retail tenants	Demographic Information Database	Information Dissemination
Security risks	Crime Cost Information, Subsidies	Information Dissemination, Monetary Incentive

Although government incentives and public/private partnerships can motivate investment, these deals tend to involve more players and result in a more complicated deal structure that uses multiple sources of equity and debt, creative public/private finance, and credit enhancement techniques, ultimately resulting in a longer (and more costly) development timeframe. Additionally, projects in economically challenged areas need a comprehensive public and private approach that can be lacking in many cities. Most investors are not interested in financing one building if the rest of the neighborhood is blighted. As one investor put it, areas with "healthy tissue"—where retail services, transportation, and adequate schools are already in place—are most attractive.

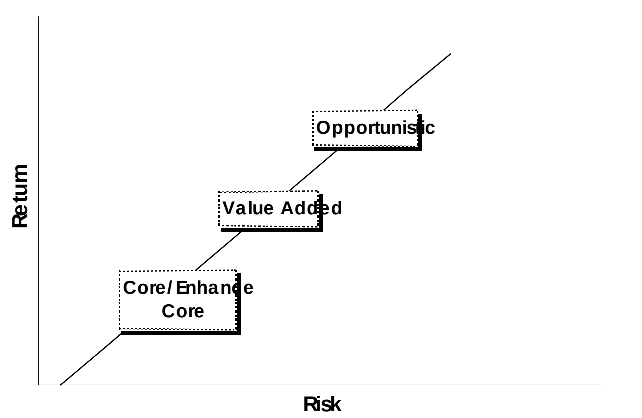
Finally, retailers are motivated to invest in economically thriving urban areas with the potential for strong sales and limited competition. A retailer that is the first to move into an unproven market is taking a major risk, which makes it more difficult for equity investors to attract tenants to projects in underserved communities. As a result, for large urban infill projects, it is often difficult to secure commitments from credit-worthy retailers. If major tenants are not secured, it may be difficult or nearly impossible to obtain financing.

~~C.~~C. Investors Need to Balance Risk and Returns

At a basic level, real estate investors focus on assets that will generate the highest possible return with the lowest level of risk. Key considerations include market timing (short term or long term hold), deal structure, the size of transaction, real estate allocations for a particular portfolio, market conditions in the property sector, and market conditions in the local market or region. All of these factors are weighed in terms of risk and return. For example, a property that cannot be disposed of quickly presents a higher risk to an investor. On the other hand, a riskier project may be justified if the returns are attractive. Therefore, inner-city projects have to measure up when judged by these criteria and must be able to compete with alternate investment choices from a risk-return standpoint.

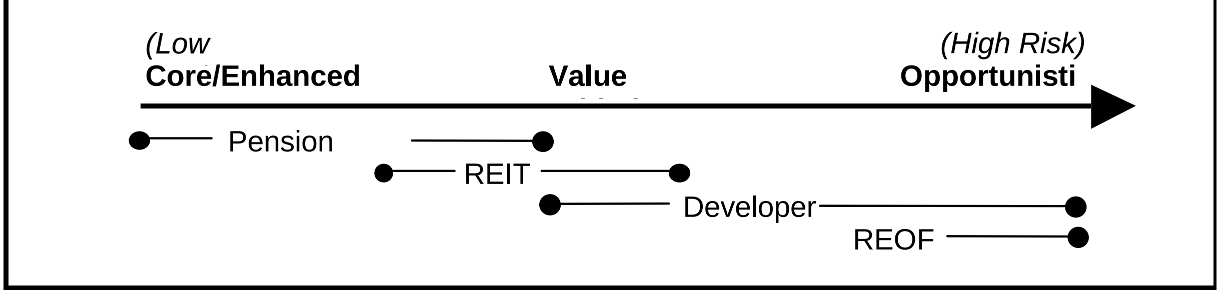
Real estate investments can generally be put into three classes: Core, Value-added, or Opportunistic. Core investments are safe, stabilized properties that generally produce steady income streams and have low risk. For core assets, investors generally seek an internal rate of return (IRR) of between 8 percent and 12 percent. Core-plus or value-added properties generally require direct equity participation and operational expertise. This may include renovating or repositioning a property to create a stable cash flow that generates property appreciation. The IRR target for value-added properties is 12 percent to 16 percent. Opportunistic investments generally involve a major capital injection into a failing property and are furthest along in the risk spectrum. For opportunistic deals, the IRR goal is 20 percent or higher.

Figure 11. Real Estate Investment Strategy



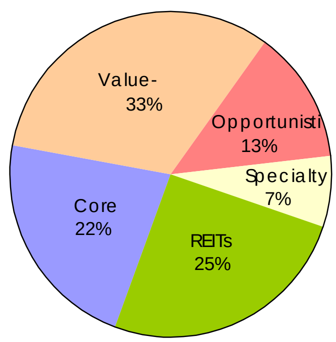
In terms of the risk spectrum for equity investors, pension funds generally target investments

Figure 12. Risk Spectrum



Public market equity players are generally risk-averse because the scrutiny of public markets imposes more discipline. This is particularly true during economic downturns. Consequently, REITs have shifted from being opportunistic buyers to focusing on core and value-added property. As public companies accountable to shareholders, REITs are in need of stable earnings to maintain share prices. As a result, they are focused on accumulating properties with sustainable cash flows. REITs have gradually disposed of non-core assets and continue to be purchasers of institutional-grade, core real estate. Pension funds have traditionally been risk averse as well. According to Institutional Real Estate, as of 2001, pension funds devoted more than 50 percent of their real estate allocations to core and value-added retail product, with opportunistic investments comprising just 13 percent of the total real estate holdings (Figure 13).[23]

Figure 13. Pension Fund 2001 Allocations*



*As of September 15

Source: *Institutional Real Estate Letter*, Institutional Real Estate, Inc.

For equity investors with a greater risk appetite, such as opportunity funds and private developers, returns of course must justify the higher risk. While government incentives and subsidies make returns on inner city projects more attractive, in general investors express that either 1) returns have not been high enough to take on the additional risk, even with government assistance or that 2) risks are hard to discern and price, making it difficult to formulate a risk-return profile for a deal. The risks associated with urban development highlighted earlier are more cumbersome and complex than typical investment risk and difficult to quantify, making a simple project with comparable returns, such as a suburban strip mall, more attractive. As a result, investors are directing capital to deals and markets where it is less difficult to build and where they can get a better handle on risk.

On the debt side, while the CMBS market gives more access to lower credit-rate borrowers, the availability of loans for purchase from primary lenders in distressed urban areas is low, explaining why higher risk loans are instead concentrated in tertiary suburban markets. Commercial

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[23] Institutional Real Estate, Inc., *Institutional Real Estate Letter, 2001.*

banks do appear, however, to be increasingly willing to lend money to urban inner-city projects when they are backed by reputable national developers and retailers, along with government financing. According to one lender, ”If you have a to-be-built supermarket-anchored center that is 80 percent pre-leased, people will throw money at you.”[24]

Developers with strong track records are not entering underserved urban communities and seeking loans for retail projects on any sizable scale, however. The Community Reinvestment Act (CRA), which requires depository institutions to lend and invest in the communities they serve, does fund commercial projects but is predominantly benefiting the development of affordable housing, because financial institutions believe that steady demand for housing mitigates risk. Retail projects that have been financed are on a smaller scale and many of the loans have been used for repositioning as opposed to new development because equity investors in the projects are usually local developers without the experience and reputation to warrant larger commitments.

Banks have financed some successful urban retail projects in distressed areas around the country, indicating that they are willing to support viable inner-city development. For example, Bank of America provided bridge, equity and construction financing to developers Katell Properties and Capital Vision Equities for their 285,000 square-foot Chesterfield Square shopping center in South Los Angeles, which opened in late 2001 and is currently performing well. The senior vice presidents of the bank’s real estate banking group both expressed that “they don’t look at South Los Angeles projects any differently than they would a project in Beverley Hills,” meaning that if the project is well thought out and there is equity in it, the lender will approve a loan regardless of the location.[25] One of the best-known inner-city retail projects, the 250,000 square-foot Harlem USA, built in 2000 in one of nation’s chronically economically disadvantaged areas, received primary financing from Chase Manhattan Bank. However, these instances are exceptions and commercial banks in general express that very few fundable inner-city projects are brought to the table.

D. The Flight to Quality is Increasing

With the current downturn in the economy, investors are even more skittish about placing money into risky deals and have become more conservative in their investment strategy. They are not only looking for solid returns but also for projects that face few obstacles with a limited amount of uncertainty. Retailers, developers, and investors alike are under pressure to improve profitability. During these risk-averse times, investors will focus on the credit quality of the retail tenants and their property owners, and there are fewer investors that will take the chance of making above-market returns on below investment-grade properties. Today, national retail chains are opening new stores very selectively and are less able to the risk on an untested location. There remains a preference for higher value locations and sure bets. Retail tenants will tend to choose to pay higher rents to enter or stay in a high traffic location, and weaker sites are sacrificed in favor of performing assets.

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[24] John McCloud, "Equity Lending: Big Purse, Tight Strings," Shopping Center World, February 1, 1999.
[25] Michael Gottlieb, "Money to Be Had," California Real Estate Journal, A Guide to California's Commercial Lenders, February 25, 2002: 3–5.

This trend has several implications for urban retail investing. Opportunistic (high-risk) investments are less attractive in this market environment. Compared with the relatively free flowing capital during the mid- to late-1990s that sought out real estate acquisitions and deals throughout the real estate risk spectrum, opportunistic plays are perhaps less attractive than value-added and core investments. This suggests that in times of economic uncertainty, less money is likely to go towards high-risk investments such as urban infill retail. The shift in Federal Realty Investment Trust's investment strategy is a case in point. The retail REIT, which had focused its strategy on urban, mixed-use development, adopted a new business plan in 2002 that moves away from the high-risk street retail properties to focus on growing the income-producing properties in its portfolio, such as traditional community shopping centers. "What really precipitated the change was risk adjustment...there are many more opportunities within that core asset base that will allow us to continue to grow and pay a higher dividend in a less risky way."[26]

[26] Beth Mattson-Teig, "A Tale of Two REITs," Shopping Center World, June 1, 2002.

IV. Some Successes

While most larger equity players such as REITs and national developers are building most of their projects in areas with a proven past performance and in less challenging markets, some are also finding opportunities in initiating new development in previously overlooked and under-invested markets. In the latter, they are "place-making," that is, developing large-scale projects that create, rather than add to, a market. These projects often require significant coordination with the local municipality and community, creative financing techniques, multiple sources of debt and equity investment, and significant commitments of time, resources and capital. Often times, cities must offer significant tax incentives or outright subsidies in order for projects to pencil out.

Equity players are going into inner-city markets for two main reasons. First, the opportunity to make a high-return investment is a major incentive. These investors have the time, resources, expertise, and risk tolerance, but they demand exceptional returns to justify these higher risk projects. Additionally, as other markets get built-out and developable land becomes more difficult to find, redevelopment opportunities in inner-city areas become more attractive. For example, markets such as St. Louis and Detroit have recently generated renewed interest and activity. These markets have been below (or off) the radar of most institutional investors for some time.

Secondly, to a lesser extent, social consciousness plays a role. Pension funds, high net-worth individuals, socially conscious funds, and some retailers are participating in social investing. Their purpose is generally to support infill development in low- and moderate-income areas. Some of these investors impose the same hurdle rates of returns for this type of investing as they do for more traditional investments, while others require a higher rate of return. CalPERS, the largest pension fund in the country, initiated a joint venture several years ago to provide equity to inner-city, urban retail projects in need of repositioning. The fund has since moved into development joint ventures with national or regional developers to develop commercial real estate in major urban centers. CalPERS' intent is to attain a respectable return while investing in otherwise overlooked or "emerging domestic markets" that may also have some of the characteristics of economically disadvantaged areas. High-net worth individuals are another source of equity for inner city retail projects. For example, former professional basketball player Earvin "Magic" Johnson was one of the major equity investors in Harlem USA. Examples of socially conscious funds include the Bay Area Smart Growth Fund (an affiliate of Pacific Coast Capital Partners, LLC) and AEW's Community Revitalization Capital (a fund managed by AEW Capital Management, LLP). Both of these groups lend to or participate as equity partners in projects in economically disadvantaged areas. However, these private funds have return targets comparable to opportunity funds.

There is evidence to suggest that funds investing in under-retailed urban areas target the higher strata of "low" income, "creaming" the projects with the fewest potential obstacles and lowest levels of risk. From the examination of selected funds and conversations with investors, it is apparent that profit-oriented investment in low-income communities are targeting areas with the easiest "wins," areas where income and spending levels are high enough to ensure a solid level of demand, and where potential risk is less. For example, investors have been highly successful with some retail projects in dense, working-class urban communities in the New York metropolitan area. The Queens Center, located in an immigrant enclave in the Queens district of New York City, boasts sales figures at $900 per square foot, nearly three times the national average.[27]

Through conversations with members of the investment community, it is evident that successful urban investment involves an effective implementation of a complex arrangement of interested parties. The most successful projects generally have the following attributes:

- Strong demand side drivers such as population density, population growth, and buying power,
- Proximity to an economically diverse metropolitan area,
- Underutilized infrastructure and central location,
- “Fast track” entitlement processes or receptive and enabling political leadership,
- Identity and visibility,
- A successful track record of public/private partnerships
- Tax incentives or subsidies, and
- Interested retailers

[27] Michael J. Berne, "Working-Class Malls," *Urban Land*, February 2002.

V. CONCLUSION AND POLICY IMPLICATIONS

Changes in the capital markets during the past decade have mixed implications for future investment and development in inner city markets. Overall, the securitization of the equity and debt markets and greater access to real estate market information have increased transparency to the market. As a result, institutions and individuals feel more comfortable about investing in real estate. On the equity side, more sources of financing are available, which means that investors can target a wider range of investments based on their risk tolerance. Therefore, there is more potential to do riskier projects in different areas, including underserved markets, as long as the returns justify the risk.

Still, it is apparent that not enough capital is going to economically disadvantaged areas. In fact, the opposite seems true. The largest institutional investors of real estate equity today, namely REITs and pension funds, are dependent on stable returns, core assets, proven markets and predictable income streams. As a result, it is unlikely that they will be drawn to the risk involved with complicated urban projects. In today's weak economy, this rings more true, as capital is even tighter and more risk averse compared to the mid- to late-1990s. Lenders and less risk-averse equity investors such as opportunity funds are more willing to look at projects in untested markets, but the barriers to entry associated with inner city development compared with suburban development have kept them away from these types of projects. Instead, they are venturing into third tier suburban markets, where higher risks are considered easier to price, yielding more favorable returns.

Though difficult to quantify, limited capital is flowing to inner-city urban areas and literally transforming communities. Motivated either by profit or social consciousness, some investors are finding pockets of opportunity in underserved communities that are generally off the radar of most investors. These types of places generally have high levels of public participation and incentives, and require significant coordination and planning. However, many of these "socially-conscious" investors are targeting urban areas that have the fewest obstacles and barriers to development. As a result, extremely distressed urban areas may receive little or no attention by the real estate community.

To provide the superior risk-adjusted returns that will draw more investors to development projects in inner city urban areas, public policy needs to focus on strategies that reduce risk and/or improve returns. On the return side, subsidies—either in the form of direct payments or in the form of tax incentives—are the main tool that public agencies have to make projects more attractive for developers. Urban areas are generally more expensive to build in and therefore subsidies are often needed for projects to pencil out. Subsidies can indirectly compensate for added costs such as higher development costs, environmental remediation, and security services. Offering subsidies can lure investors and developers by making it possible to achieve higher returns to justify the added risk that inner city developments pose. On the other hand, direct subsidies have the potential to distort market forces, and make it more likely that developers will build, irrespective of whether the project makes economic sense or if demand for the product exists.

Looking at the risk side, because barriers to inner-city urban development create risks that are difficult to quantify, perceived development risks might be greater than real risks. Policies that promote information dissemination to create greater transparency would help remove these barriers and bridge the gap between real and perceived risks. This would in turn allow investors to better price risk when making investment decisions. For example:

- A database with detailed land parcel information would allow a developer to determine in advance the difficulty of land assembly.

- Information databases could also be used to help determine demand conditions in the market. Demographic information about local residents in a trade area is readily available, but combining this information with a database of daytime office and factory workers who are potential customers could give developers a better sense of their customer base and help them attract reputable retail tenants. A multiple listing service of available space would provide another avenue to get information into potential tenants' hands.

- Higher levels of crime are often associated with urban, inner city areas. However crime varies greatly from neighborhood to neighborhood, and developers may perceive that security risks in a given area are greater than they really are. As with general demographic information, crime statistics are publicly available, but information could also be gathered on actual costs incurred by local property owners as a result of crime (i.e. theft, vandalism) or protecting against it (i.e. security services). By providing this information, public agencies could help developers determine what the actual security risk in a given trade area is so that they can account for this cost in determining the economics of a deal.

In addition to providing more information, direct assistance in overcoming barriers to inner-city development would also help reduce risk. Successful retail projects developed in underserved communities have to a large extent been undertaken by partnerships where public entities have played a significant role. Government involvement in these projects provides useful lessons for other communities trying to do the same thing. Public agencies have been involved in a variety of roles, from shoring up community support to assembling development teams and financing to lobbying national retailers. Other ways government can help reduce barriers and mitigate risks involve taking some of the unknown costs out of developing in urban areas. Environmental remediation and the city approval process add risk in urban projects because they often take longer than expected to resolve, adding costs that are difficult to quantify going into a project. By guaranteeing fast-track city approval and providing developers with land that has already been cleaned up, government agencies can take these risks out of the equation.