FINANCING NEW URBANISM

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EXECUTIVE SUMMARY

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Over the last two decades, only a few New Urbanism projects have been built. These include Laguna West in California, Kentlands in Maryland, and Celebration in Florida. The question that arises is whether current lending and investment practices constrain NU developments. Leading developers, equity investors and lenders agree that NU projects are more costly and complex (therefore riskier) than conventional planned communities. Unless a project can generate sufficiently high cash flows in the early years it will not be perceived as financially viable. Neither Fannie Mae nor Freddie Mac currently plays a significant role in financing or securitization of mortgage debt on NU projects. NU developers could ease their financial burden by creating relationships with long-term equity players, such as pension funds and endowments. Documenting NU development over a full real estate cycle should help lower the level of perceived risk.

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[Sidebar: The majority of lenders, equity investors, and developers believe that mixed-use projects are inherently more complicated, more difficult to bring to a successful conclusion and, hence, riskier. How does this affect New Urbanism?]

New Urbanism and associated planning strategies such as traditional neighborhood development, neotraditional development, smart growth, and walkable communities, refer to master-planned communities characterized by compact, diverse neighborhoods and mixed-use town centers (see *WRER*, Fall 1998). Such designs ensure that many of the activities of daily life can take place within walking distance of community residents' homes.

Over the last two decades, as the concept of New Urbanism (NU) has found favor with many planners, some developers, and most of the public, a few projects have been built, including Laguna West in California, Kentlands in Maryland, and Celebration in Florida. Given the small number of projects developed, one question that arises is whether current lending and investment practices constrain NU developments. To answer this question, a cross-section of opinion from the real estate industry, leading developers, lenders, and equity investors was compiled. Of the 55 individuals contacted, 23 agreed to be interviewed. The telephone survey took the form of a detailed questionnaire and interview. Developers from across the United States (e.g. California, Florida, Georgia, Tennessee, Oregon, North Carolina, Pennsylvania) accounted for about half the group; the rest were capital managers, financiers, investment bankers, and investors. While twenty-three respondents are hardly sufficient to provide statistical validity, this survey provides important insights into how financing practices and availability of funding vary by type of lender/investor, by property and asset type, and by location (urban/suburban/infill/greenfield).

RELATIVE COST AND RISK

The builders, lenders, and investors who were surveyed generally expressed familiarity or direct experience with NU projects (out of 23 respondents, 22 were familiar with the NU concept, and 18 indicated that they had had experience with NU or similar projects). The results show near unanimous agreement that NU projects are more costly than single-purpose or single-product type developments (scale-adjusted, of course). There are several reasons for higher costs. Building at a higher density is itself more costly. While there can be savings associated with some NU features such as smaller lots, the presence of multiple uses, or multiple types of a given product (e.g. a mixture of apartments, detached houses and rowhouses) means that the scale economies associated with mass-producing a single product often cannot be realized. A number of developers also noted that the non-standard nature of many multiple-use developments means that well-known engineering practices utilized in, say, suburban tract housing, cannot be applied.

Greenfield developments also are considered more expensive since the infrastructure investment required by NU projects (e.g. rear lanes) is more elaborate than that associated with standard platt housing. Nevertheless, few interviewees believed the extra costs associated with NU to be much above ten percent of overall project value, and some believed them to be less than ten percent. However, neither equity investors nor lenders perceived extra costs to be a major obstacle to the financing of a well-conceived NU project.

More important for the availability and cost of NU project financing is their higher perceived risk. The lender/investor interviewees were unanimous, with the developers generally agreeing, that the complexity of developing and meshing multiple uses in a single development raises risk. This risk factor is due to the multiple uses involved, not to the NU nature of the projects *per se*. That is, complexity raises risk, and NU projects are complex. Complexity also tends to make each project unique, and lenders and investors generally attach significant return premia to non-standard investments. Many financiers also emphasized that it is difficult to predict accurately the demand for projects with multiple property types—whether there are NU features involved or not. In addition, the fact that most developers typically specialize in one product type raises the risk of multiple project development. Large NU projects require superior management skills across a range of product types in order to properly phase the development of multiple uses so as to minimize costs and coordinate cash inflows to satisfy lenders and equity investors. Small and inexperienced developers, in particular, are perceived to lack this skill set.

Beyond the higher perceived risk of multiple-use development, there are additional risk premia specifically associated with NU projects. Some respondents expressed concern about the depth of market demand for the NU product. This fear appeared to be least strong for urban infill developments, as there was less doubt about the willingness of urbanites to accept higher densities and multiple uses in their neighborhoods. The perception among the survey respondents was different for the suburbs, where public debate about higher densities (combined with NIMBY problems) can raise the perceived risks of NU developments even after entitlements are received. These risks were felt to be greatest for greenfield projects, although other factors such as higher up-front infrastructure costs and the ability of NU town center retail to compete against nearby strip centers also raised perceived risk.

Complexity and perceived risk have a cost. No financier, whether on the debt or equity side, thought that multiple-use NU projects on average should have a required rate of return of less than 15 percent.

FINANCING DIFFICULTIES

The survey results suggest that some lenders are prepared to finance the entirety of a multiple-use project, whether or not it is NU. However, the majority of lenders and investors interviewed noted that their policy was to *pro forma* each property type separately, evaluating the overall project as a weighted average of the individual property types. One reason they did this was because they viewed their collateral as component parts of the project that could be sold off separately in the event of a default and foreclosure. In other words, individual property type evaluations are important to them for fundamental business reasons. In addition, lenders and investors generally were skeptical that the typical developer is adept enough to build more than one property type. They maintained there were relatively few developers with successful track records of multiple-use projects, a factor which motivated careful scrutiny of each property type. In addition, the financiers in the survey tended to be more comfortable lending against or investing in one product type (per deal). The process of evaluation by property type does not mean that a NU project will have multiple financing sources, although that is what happens in many cases.

While the survey respondents suggested that overall evaluation costs are generally higher for NU deals, the difference was felt to be modest compared to overall project value. The real onerousness of the financing environment for NU developers arises from the higher perceived risk associated with multiple-use projects combined with the newness of the NU concept. Higher risk leads to higher discount rates applied to cash flows. A standard discounted cash flow calculation indicates that, with a required rate of return of 18 percent, the present value of a dollar five years from now is only 44 cents; the present value of a dollar ten years from now is only 19 cents. High discount rates mean that cash flow in the longer-term future has little value to the typical lender or investor. Unless a project can generate sufficiently high cash flows in the early years (when its costs are also higher) it will not be perceived as financially viable. That almost certainly is why, since the gestation period of large NU projects is mid- or long-term, many capital market participants will not finance them, or will finance them only if they have strong guarantees, or are assured that carefully planned phasing of the development will generate cash early in the project life.

This need for good financial, as well as project-level, planning led several interviewees, lenders as well as developers, to suggest that the complexity of large mixed-use projects, including NU projects, was best handled by correspondingly large development organizations. Large organizations are perceived to have broader resources with respect to management and easier access to capital. In other words, large organizations lower the risk perceived by lenders. Conversely, interviewees from the financial community tend to believe that smaller, and less experienced NU developers should work on smaller, simpler projects. As in venture capital deals, this also suggests that low debt ratios are justified; that is, if you are a believer, put up the money.

The respondents also indicated that a difference in return requirements, not a difference in project evaluation methodologies, is the most important way in which lenders differ in terms of financing NU projects. Banks, investment banks, and opportunity funds tend to have investment horizons that impose relatively high rates of return on NU projects, with investment banks and opportunity funds tending to have the highest return requirements. With an internal rate of return hurdle in the high teens, the discounted cash flow approach used by these financiers means they are likely to be interested only in projects with relatively short payoff periods.

Some pension funds and endowments, along with certain corporations, have lower return requirements. Such corporations, which include some real estate investment trusts

(REITs), have access to their own balance sheet to finance longer-term projects. NU developments are being done by a select group of firms including Federal Realty Trust and Forrest City. Pension and endowment funds, as well as insurance companies, often have fairly well-known liability streams of long duration that they need to match with cash flows from assets. Longer-term real estate investments, possibly in NU projects, can provide those cash flows. In return, the fund may be willing to accept a lower required return–making the longer-term project appear more financially viable to them for the reason discussed above. In addition, the long investment horizon of pension and endowment funds may lead them to have different (lower, in this case) return requirements in general. This, too, may make them more amenable to taking positions in the back end of long-term deals. However, many pension and endowment funds were burned by the large planned unit developments of the 1980s, which has made them averse to risk.

GREENFIELD VS. INFILL PROJECTS

One of the striking insights from the survey is the very different attitudes of both debt and equity financiers towards greenfield versus infill projects (whether urban or suburban). As noted above, NU developments in infill areas are viewed as relatively risky, but there is a general opinion that well-done, multiple-use development can be profitable if: the payback period is short enough; the site is acquired at below replacement cost; and the project is focused on a dominant product type that the financier understands.

Financing for greenfield NU developments is another case entirely. Basically, the respondents from the lender and equity investor communities view the history of such projects unfavorably and--with good reason, based on history--believe such deals are not financially viable for anyone without a corporate balance sheet to lean on. (The Walt Disney Company's development of Celebration was frequently cited as an example.) The financial community is particularly skeptical that town center retail can be made to work in such settings. Respondents observed that successful retail must serve a market area much broader than a subdivision or small town. Competing with low-cost suburban strip retail, which requires a minimal investment for infrastructure, struck many respondents as highly risky, if not impossible. The retail issue aside, the vast majority believed the carry cost associated with up-front infrastructure investment to be so large as to make the projects non-viable for all but large companies with access to internal capital. That is, if one must put in a town center early, the subsidy required would kill the deal from their perspective. While some NU developers optimistically compared the up-front cost of a town center to traditional subsidized community amenities such as golf courses and club houses, there was general skepticism about extended subsidies to retail or commercial uses that add questionable value.

The unanimity and forcefulness of the capital market respondents on these issues leads us to question the viability of future private sector financing for suburban greenfield NU projects. We believe that for such projects to be done in even moderately large numbers a large amount of owner equity, or some type of public sector intervention, will be required. The latter might take the form of partial financial guarantees or credit enhancements. A sound economic rationale for any such intervention and for the use of governmental resources requires that NU projects deliver a social benefit that does not arise from, say, the typical master-planned community. Such benefits might take the form of lower pollution, for example, as a result of higher density, or reduced time in traffic, or greater opportunities for walking. We do not know whether such benefits exist.

All respondents agreed that NU projects need to be fully entitled for firm financial commitments to be made. However, since this is also true for non-NU projects, the real issue is whether the entitlement process is more burdensome for NU projects. Notwithstanding the published claims of many NU proponents, the general opinion expressed by developers in the survey was that entitlements were not a major obstacle. They felt that many communities, particularly those with professional planning staffs, increasingly appreciated the benefits of multiple uses and multiple product types and were forthcoming with entitlements on good projects, including NU projects. The only exceptions to this were a few comments that some communities without existing high density development would fight hard against density, slowing the approval process. While this may be a problem for NU developments in traditional suburban areas, our respondents suggests that it is not an obstacle in urban infill areas, nor on the urban fringe. Many of the survey respondents believed that NU projects were not more burdened by the entitlement process than non-NU projects, with some respondents believing that NU projects might actually be looked upon in an increasingly favorable light by certain communities.

SECONDARY MARKETS

The Federal National Mortgage Association (Fannie Mae) is by far the largest purchaser and securitizer of single-family mortgage product in the nation (and the world), followed by the Federal Home Loan Mortgage Corporation (Freddie Mac). The added liquidity these secondary market agencies provide, and lower interest rates associated with that liquidity, have been studied by a number of scholars, government agencies, and housing industry associations. This research suggests that conventional mortgage interest rates are from 15-30 basis points lower than those on non-conforming loans because of the liquidity provided by Fannie Mae and Freddie Mae in the conforming loan markets.

Unfortunately for NU developers, neither Fannie Mae or Freddie Mac currently plays a significant role in the financing or securitization of mortgage debt on NU projects. Nor are they likely to do so in the near future. Both Fannie Mae and Freddie Mac place limits on the fraction of space and rents that can arise from non-residential property types (i.e. commercial, retail) in the projects that they fund. For example, to be eligible for Freddie Mac's Multifamily Streamlined Refinance Program, a project cannot have non-residential rents exceeding 25 percent of effective gross revenue or have non-residential tenants occupying more than 25 percent of the square footage of the improvements. Fannie Mae's limits on non-residential activity can be even more stringent. According to materials provided by Fannie Mae's Multifamily Management Team, there is a 20 percent limit on non-residential square footage for all product types (including negotiated transactions). Fannie Mae also has restrictions on the fraction of project income that may arise from non-residential rents.

The chief reason for Fannie Mae's restrictions is the agency's charter, which commits it to a focus on the residential sector. Fannie Mae has interpreted that charter to mean that projects with substantial non-residential components are not legitimate business targets. This excludes most NU projects.

Fannie Mae’s charter is silent on precise limitations, so the percentages noted above were presumably set by the agency’s senior management. While we were not able to elicit any specific comment from Fannie Mae officials, we do not think it is particularly difficult to understand their reasoning. While wielding substantial political power in its own right, the agency is under increasing pressure from Wall Street firms and mortgage servicing firms not to increase its scope of activities and encroach on other players in the residential sector. In 1999, FM Watch, a well-funded watchdog group of private sector firms, was founded to monitor the situation. Given the relatively small number of NU projects, and the fact that retail and office developments obviously are not housing--even if done in conjunction with housing--it probably is not worth the added political risk for Fannie Mae to be more venturesome in this area.

While Fannie Mae has funded a small number of NU projects with overwhelming housing components (including two developed by people we interviewed), even if the agency entered more actively the arena, we suspect they would not view the risks any differently. Thus, relatively high interest rates on limited loans would likely be charged to compensate for the relatively high risks of multiple-use projects generally and NU projects specifically.

EASING THE PAIN

The simplest solution to the problems associated with higher perceived risk is for owners of NU projects to put up their own equity--after all, not all new ideas deserve debt or lenders' equity. A solution suggested by some NU developers is for financiers to change their approach to project evaluation. No doubt, the discounted present value approach, which forces relatively rapid payback on high perceived risk projects, is conservative. Yet it is undoubtedly socially beneficial for banking institutions with federal or state deposit insurance to adopt conservative evaluation practices so that government bail-out costs are minimized. Even absent deposit insurance, the adoption in recent years of the discounted cash flow methodology reflects sound financial analysis. The fact that this approach to project evaluation is highly unlikely to change in the near future, means that the issue almost certainly needs to be dealt with in another manner.

A more practical way in which NU developers could ease their financing burden is by working harder at creating relationships with long-term equity players, such as pension funds and endowments. We were surprised that very few of the NU developers interviewed had developed such relationships. This concept is not unknown to the development or Wall Street community. In fact, Chris Leinberger and Robert Davis, writing in *Thresholds*, have coined the term "time tranching" to describe it. The idea is to have the most patient capital source have a large stake in the back end value of the deal, with other investors/lenders having higher required returns receiving the bulk of the early period returns. While this strikes us as a useful strategy that should be investigated by other NU developers, the number of pension and endowment funds is a small fraction of total possible capital sources. Hence, the number of patient capital sources available to wait for the value in long-term projects is limited.

Accommodating capital sources with different investment horizons and return requirements also suggests that NU developers should give heightened attention to the details of how they phase in the different uses in their projects. Careful structuring and cash flow management is needed on the developer side so that some component of the development is generating cash flow quickly--a difficult task. Even if a pension or endowment fund is willing to take most of its return in terms of longer term capital appreciation, the shorter-term needs of other capital sources must be accounted for–unless the patient capital is willing to finance the entire deal (which very rarely happens, according to our respondents).

Another way to mitigate risk is to have a dominant property or product type. One interviewee noted that the Trammell Crow Company had developed a product with multifamily over retail. However, this company designed the first floor retail so that it could be rented as studios, with the *pro forma* assuming these spaces are multi-family residential. A similar strategy could increase the array of project lenders and investors for NU developers. And, the more capital sources competing to invest in a deal, the lower will be the all-in financing costs. This is a lesson NU developers need to learn even if it means altering the design of their projects.

Finally, better historical data will help the financial community understand and better evaluate NU projects. It is important that such data be collected on a systematic basis. Lenders and investors already know the typical performance of standard ULI product types. If NU developments do make money in the long-run, documenting the fact should help lower the level of risk perceived by financiers.

Critics point out that few NU projects done in the last five years have been financially successful. NU advocates respond that these projects are still relatively new, and there is not yet data spanning a full real estate cycle. Data collection and analysis of the multiple-use developments of various parts of the nation’s towns and cities that are conceptually similar to NU would be useful. The need for data collection and analysis is reinforced by the fact that we found no capital market source inherently hostile to the concept of New Urbanism (except in the case of large, greenfield developments). "If it works, we'll finance it," is the general attitude. If NU projects can be shown to be less risky than currently perceived, and if successful strategies for assuring short-term cash flow are in place, lenders will compete with one another and interest rates on loans and required rates of return on invested equity for NU developments can both be expected to fall.

[Endnote: This research was commissioned by the Congress for a New Urbanism. Adam Barzilay and Anthony Pennington Cross assisted in the work. This article was published in a different form in *Housing Policy Debate*.]