The New World of Mixed Use Community Development

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As we emerge from the current economic slump—the most severe real estate downturn since the great depression —most builders, developers, land owners, and investors will be surprised to discover fundamental changes which have occurred while they have been preoccupied on survival, or focusing on other business areas. ***The world of development has changed. There is a new paradigm relative to financing, market segments, market preferences and entitlements.***

Real estate investment involves four different risk profiles—entitlement risk, financial risk, market risk and partnering risk. All four of these will be substantially different in the future with regards to mixed use communities. Those who recognize, adapt and take advantage of these changes will prosper, while those who expect the new normal to be the old normal, will not. This paper examines the changing world of mixed use community development.

Financing: Shrinking Opportunity

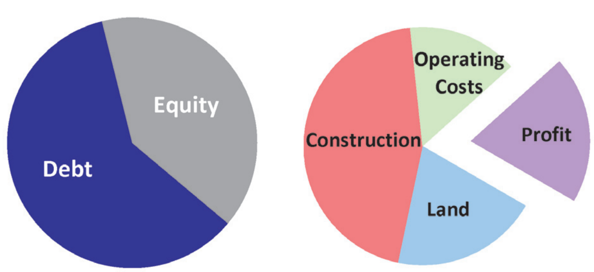
One of the most evident repercussions of the current real estate crash is its impact on financing. Going forward, debt will be much more difficult to obtain for land development activities. The banks are already telling us that in the future, when they do recommence lending for acquisition and development, the equity component will need to be greater than in the past. ***Where we previously were able to borrow 65-85% of the value of the real estate, in the future the range may be closer to 50%.***

Even at reduced lending levels, it is not clear from where this debt will come. Our conventional sources of bank debt are now burdened with additional regulation, which will make some bank debt either a smaller portion of the picture, or possibly no player at all. It is also expected that the cost of bank debt will be greater. Community Development Districts, another form of debt used successfully to finance large communities, have also been burned and will likely expect higher returns and additional guarantees to protect the bondholders. While new sources of debt financing could develop, debt will be more costly than in the past, and more difficult to obtain due to the recognized risks of real estate development. Expect all debt providers to require other forms of assurances, such as personal and corporate guarantees. Another financing issue will likely include less total cash-out for land sellers, meaning more owner-financing for a portion of the land purchase.

Cost of Capital: Rising Cost

Capital consists of a debt component and an equity component. These components are usually weighted and blended to create a "cost of capital" percentage. Since debt is less expensive than equity, it has traditionally commanded a higher share of the total capital in order to keep the blended cost of capital as low as possible. Since equity will most likely be at a higher percentage of total capital in the future, the cost of capital will undoubtedly increase. Referring to Figure 1, if the cost of capital increases, and developers are to maintain profitability, then something has to go down to balance out the additional costs. The land price has to go down, construction costs have to go down, or operating expenses have to go down, or all three. If profits were to go down, then very few people will want to be in the development business due to its inherent risk and lower reward.

Figure 1 – Capital Sources and Uses

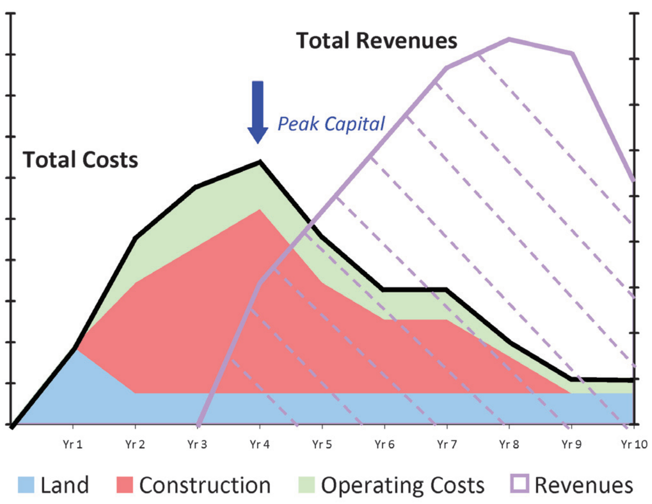


Capital Sources *Capital Uses*

Another significant component for land development, relative to capital, is the peak capital requirement. Figure 2 shows the typical mixed use community cash flow cycle. ***To reduce the peak capital requirement in the future, we will need to see lower upfront costs (smaller initial***

phases), have a more timely revenue stream, and shift major costs (such as amenities) to as late as possible in the development cycle, until revenues can support the costs. This requires market acceptance of the fact that not all amenities, infrastructure, and community elements will be provided up front in the first phase. This is a dilemma since consumers, especially Baby Boomers, want the amenities available up front for immediate gratification, and as proof that the developer is financially solid. Buyers will not easily forget the troubled communities abandoned by bankrupt builder/developers from the current recession. Another change that may evolve to lessen risk and manage peak capital requirements is the creation of higher density small-scale (200-300 homes) mixed use communities, located in more urban areas. Here, the nearby amenities will be critical since internal amenities in this type of community would be scaled down.

Figure 2 – Mixed Use Community Typical Cash Flow Cycle



The Market: Demographics are in Our Favor

One factor that is very encouraging, relative to the current economic down-cycle, is that future demographics are favorable on two fronts. First, we have 77 million Baby Boomers who are now in the peak spending and net worth phase of their life, with the first wave of boomers turning 65 in 2011. As the market rebounds, this will provide a great opportunity for retirement housing for several years to come. Second, another age generation, referred to as the Echo-Boomers or Y-Generation, is equally strong in numbers. Although of much lower economic means right now compared to the boomers, this generation is moving into entry-level housing and rental apartments, and will prefer a lifestyle that includes active town centers, downtown areas, and entertainment venues.

We will see more singles in the housing market than ever before. It is estimated that soon the percentage of singles looking for housing will be the same as the percentage of traditional nuclear families seeking housing. The era of "trophy" homes and "McMansions" has essentially come to an end, and we will see a more disciplined relationship of home price to income levels and/or net worth levels for homes being purchased. This will mean smaller homes, smaller lots, and overall more dense products. Will the market accept the higher density (meaning stacked product), or residential over commercial housing options? It may not have a choice due to regulatory and price considerations.

Lifestyle: Practical Amenity Development

Due to the need to lower the peak capital and the significant initial investment of a mixed use community development, not all amenities can be constructed up front, given that the cost of capital and carry will be much higher. We are likely to see only those amenities that do not result in high capital or high operational costs, meaning that golf will be very difficult to justify. One lesson well-learned from the current market is that it is better to be "under-golfed" than "over-golfed." High operational costs, environmental impacts, required water supply, and the large land footprint required will limit the number of golf courses in the future.

Single-use product developments will be replaced by mixed use developments that provide the convenience and amenity of retail, restaurants, and health providers - these will be the new amenities. Walking paths have been one of the top-ranked amenities for several years, and will continue to be so into the future. Biking, hiking, fitness, wellness, nutrition, and organic farming will also be key amenities going forward.

Transportation costs have been a growing component of overall expenses for families, and a lower cost of transportation will be considered an amenity that will help drive absorption for specific market segments. Alternative modes of transportation, such as walking, biking, neighborhood electric vehicles (NEV's) and public transit will play a much larger role, relative to marketing a new community, and relative to obtaining approvals.

Builders: Back to the Future

Public builders have experienced substantial losses and devaluation of their stock, due to extensive land inventory on their books, pulling down their return on capital. ***Expect a severe contraction in the number of builders who develop their own large-scale communities in the future.*** Certainly, products like active adult communities are more conducive to vertically-integrated builder/developers. Smaller projects, including infill and redevelopment projects, also lend themselves to builders integrating with the land development aspect.

Relative to mixed use communities, it is expected that builder take-downs will be in smaller increments, providing a one year to 18-month inventory maximum. Some larger builders may take down "super pads", large tracks that include 50 to 200 lots within a mixed use community. Within those super pads, builders may do the land development, depending on the market and entitlement risk.

Land Use Entitlements: Paradigm Shift Underway

In Florida, there has been a paradigm shift underway, regarding land use approvals, and more changes are on the way. Smart Growth initiatives, which began about 10 years ago, spawned the planning and architectural concept of traditional neighborhood developments (TND), sometimes referred to as neo-traditional development. Governmental regulators have looked favorably on this type of development, seeing them as a return to hometown values, by providing walk-ability and interconnection of streets, integrated into a compact community fabric. ***With the growing focus on global warming and greenhouse gas emissions, the need for energy conservation, alternative energy supply, alternative transportation modes and clustered higher density development have all come to the regulatory forefront.***

Florida House Bill 697, signed in 2008, focuses on energy conservation, management and supply. It directs the State Department of Community Affairs (DCA) to implement regulations in land use. DCA is likely to look favorably on developments that provide the following: clustering; lower vehicle miles traveled (VMT); creative transportation systems; close proximity to existing urban areas; or infill development. Greenfield developments will likely be limited to large-scale New Towns that have extensive open space and a mix of uses, including retail and job centers, to minimize external trips. Smaller single-use developments in greenfield areas will be extremely difficult, if not impossible, to achieve approvals. Due to the higher entitlement and mitigation costs, it is likely that homes will be more expensive the further you move out and less expensive the closer you move towards urban centers. This reverses the trend of suburban development which has occurred over the past 50 years; the sprawling pattern generally resulting from lower priced land farther away from the urban centers, combined with a historically flexible regulatory environment.

If the market is to accept more dense development in urban centers, the government will have to do its part in providing common infrastructure in those areas— including roads, transit, parks, drainage, parking, beautification and most importantly, safety. Public investment and incentives are necessary for this higher densification development, and for a residential market to be attracted to the urban centers. It cannot happen simply by regulating it to happen.

In 2009, Florida Senate Bill 360 was approved which, among other things, exempts requirements for Development of Regional Impacts (DRI's) and transportation concurrency in dense urban land areas (DULA's). It further requires a future mobility fee to take the place of transportation concurrency and impact fees. This bill sends a significant message as to where the state expects new growth to occur, and encourages growth in the current urban areas that are already dense and developed. Conversely, it will be very difficult in greenfield areas to meet state requirements for comprehensive plan amendments, DRI's and transportation concurrency.

Another significant land use issue will be Hometown Democracy, which is slated for the 2010 state ballot as a constitutional amendment. Hometown Democracy requires that all comprehensive plan amendments be processed by public referendum. If passed, future comprehensive land use plan amendments will become very expensive, very unpredictable and very political. Ironically, many residents of dense areas are weary of growth and higher density, and will likely vote against the increased density that has been actively encouraged and incentivized by recent state legislation. Conversely, rural areas that want the growth, and have felt left out for many years, are more likely to pass referendums supporting growth. Even if the Hometown Democracy amendment does not pass at the state level, there is a good chance that similar movements will occur at city and county levels, creating similar results. So, permitting of development will be much more difficult and expensive, possibly to the extent that more strict regulations will limit the rate of Florida's growth.

Environmental Entitlements: Expanding Jurisdiction

During this severe market downturn, environmental regulators and non-governmental organizations have taken the opportunity to push agendas to strengthen environmental requirements and further restrict new development. The development industry has not had the manpower or the financial resources to be effective in providing a business balance to some of these regulatory initiatives. The federal government, through Senate Bill 787, is now looking to expand its jurisdiction, regulating virtually every small pond and ditch; this is similar to the power they wielded in the 90's, and possibly even more extensive. Species issues will become more difficult to address and more expensive to mitigate. Environmental lands slated for future preservation and designated as such on maps, funded or not, could fuel reasons to deny new developments in outlying areas.

Water supply will be a critical issue, potentially a show stopper. The water management districts in Florida are severely limiting new withdrawals, and in some cases, stating that no new withdrawal permits will be issued from current aquifer sources. Water conservation will also be crucial going forward, with an emphasis on finding additional conservation measures and being a less consumptive state than we have been in the past. Water quality will continue to be a contentious issue, with new statewide nutrient-loading standards imminent. Low impact development will become the new standard, requiring more hands-on and intensive design. These techniques will not fit well with the past production mode of construction and development.

The new regulation looming is greenhouse gases, and greenhouse gas reduction will be the new battleground for stopping development. This has already taken hold in California, and will create an entirely new land development consulting industry. The good news is that mixed use community developments have the opportunity to design for a mix of uses, lower vehicle miles traveled, energy conservation, carbon offsets and alternative transportation systems, all of which will be new design parameters for approvability.

Community outreach, alliances, partnering and interaction with potential development opposition will be standard procedure to gain approvals. Openness, honesty, listening to concerns, taking time to work out differences, and creating an overall public benefit will be essential elements. This must be done early in the planning process, not when approval hearings have already been scheduled.

Summary and Conclusion

The new world of mixed use community development will be substantially different from the old world. It will be more expensive and require different skills and knowledge. While some elements remain fuzzy and unfocused, some things are clear: the financial structures, the market, the entitlements and the partnering must all work together in balance to create a successful community with attractive returns. Now is the time to plan for the changes in order to be ready for what appears to be a very strong market rebound two to three years out. Those "asleep at the switch" will likely lose tremendous potential land value in the years ahead. ***Those who look to capitalize on change and take advantage of opportunities that the new world brings to mixed use community development will prosper.***

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