



FINANCING AND CAPITAL SOURCES

aside a fund for investment in affordable housing. So far, they are the only public pension fund that seems to be pursuing such a policy.

We compiled a national listing of headquarters for private pension funds with over twenty million dollars in business annually. The overwhelming majority are in New England and in the Midwestern U.S. There is currently interest in Oregon as an investment market nationally, according to Nomura Securities of New York, but the interest has been primarily in pooled apartment acquisitions that can be restructured as real estate investment trusts which allow investment with less capital risk than single property investment. There is little willingness to invest directly in single projects. US Alpha, the representative for the largest Dutch pension fund, stated that as a secondary market Oregon is not currently considered for real estate investment.

Pension funds and their managers control one of the largest sources of investment capital in the world, something over \$3 trillion. Consequently, there is strong competition from investment houses, brokerages and even corporations for the use of this capital. Because of the problems of the late 1980's real estate markets, the "prudent investor" rationale has been strengthened. Where, previously, fiduciary responsibility dictated a prudent standard (what would the prudent person do?), now specific expertise is not only expected but demanded, and investments are expected to be minimally risky. Thus, when and if pension funds begin to invest directly in real estate, the most likely investments will be in low-risk projects with long-term track records of success. There is little likelihood that pension funds will soon be providing capital for Smart Development projects unless the ownership can be structured to insulate them from risk.

Privately held pension funds in the U.S. with over \$50 million in assets or volume:

Eaton Vance Corp
Boston MA 02110
Assets: \$100-\$500 Million

Integrated Resources Intl
New York NY 10003
Assets: \$500 Million-\$1 Billion

John Hancock Mutual Life Ins
Boston MA 02116
Sales: Over \$1 Billion

Metropolitan Life Insurance
New York NY 10010
Sales: Over \$1 Billion

New England
Boston MA 02116
Sales: Over \$1 Billion

New York Life Insurance
New York NY 10010
Sales: Over \$1 Billion

Unum Corp
Portland Me 04102
Sales: Over \$1 Billion

Equitable Co
New York NY 10019
Sales: Over \$1 Billion

Phoenix Mutual Life Ins Co
Hartford CT 06103
Sales: Over \$1 Billion

BEA Assoc
New York NY 10022
Sales: \$50-\$100 Million





Lenders and Financing

The face of development in Oregon is changing. Once seen as a haven for the small builder, land pricing, material costs and consumer competition for housing have risen at a rapid rate. At the same time, Oregon has come to the notice of large builders, and while few have moved into this market yet, at least one is offering competition within the Portland market.

The result is that profit margins for land development and construction have slipped, producing a housing market more competitive for developers than ever before. When asking lenders about Smart Development, Leland Consulting Group was told unequivocally that to finance anything unusual required clear limits on the risk the lender could accept.

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In compiling lists of local lenders with the capacity to finance significant development, we learned that there are relatively few lending institutions doing over ten million dollars of business annually in Oregon (see the list on the following pages). We surveyed lenders in Oregon to gain information about their willingness to fund Smart Development. We learned that far from being unwilling to lend on innovative projects, lenders are willing to lend on a wide variety of project types if their requirements for lowering risk can be met. We surveyed lenders in four categories: the developer; project management and pre-leasing; the willingness of the institution to lend; and the importance of comparables.

Developers

First on any lender’s list is a developer with a track record and financial capacity to carry risk. Lenders strongly preferred developers with experience in the product type and felt it was somewhat important that the developer come from the local area. The capacity of the developer’s organization was an issue for some lenders. Some lenders would lend to developers with a building capacity as low as one to nine units per year, while others would not lend to those with a capacity of less than 50 to 100 units per year.

Individual lenders surveyed:

John Bradshaw, Vice President
North Coast Mortgage
888 SW 5th Avenue, Suite 1450
Portland, OR 97204

Clifford Rone, Vice President
U.S. Bank of Oregon
111 SW 5th Avenue, T-7
Portland, OR 97204

John Peterson, Vice President
Bank of America Oregon
1001 SW 5th Avenue, 21st Floor
Portland, OR 97204

Larry Remmers, Sr., Vice President
First Interstate Bank
1300 SW 5th Avenue
P.O. Box 3131
Portland, OR 97208





Obstacles to Financing Smart Development

In asking lenders about the obstacles to Smart Development we discovered that the purposes for pursuing, and the demographics and market for building pedestrian-oriented, grid-platted, transit-oriented development are not clear to developers and lenders.

Neotraditional, transit-oriented, small-lot housing, pedestrian-oriented and mixed-use and grid-platting have been bundled as a single concept by architects. In studying the markets for these projects, however, we discovered that the demographics for existing project types are not the same. For instance, rail-oriented development captures a 25 to 45-year-old upscale mostly singles market while single-family detached neotraditional projects have appealed to buyers over age 45 whose children have left home. Projects which mix up these concepts and fail to target the correct demographic group are at a very high risk for failure because the two markets are composed of radically different social groups. Moreover, new urbanism projects have gained a reputation for not hitting market pricing competitively.

The lack of clarity in addressing markets and the target demographics for differing development styles has produced skepticism about New Urbanism. The fact that the variety of concepts have been bundled as a single ideal has tended to produce resistance to each of the concepts individually by developers and lenders. When we considered our successful project examples we realized that projects which satisfy some goals are unlikely to satisfy others because the goals have consequences, when built in current markets, which are in conflict.

- A nationwide search for projects which embodied the ideals of Smart Development yielded over 60 project examples but only around 15 built projects with a record of success. Notably, none of the projects was able to contain all of the goals of Smart Development.
- Concepts need to be un-bundled to simplify project execution. Transit-oriented development has specific markets that are not the same as the markets for single-family detached housing or free-standing multifamily apartments. Retail development is a separate category with its own requirements for market capture, access and management. Developers and lenders understand these types as separate markets requiring separate sets of expertise to execute successfully.
- Neotraditional development satisfies a desire for community—it need not have high-density, high architectural style, or great complexity to succeed. The developments that most typify this style in Portland (Laurelhurst, Ladd’s Addition, Irvington, etc.) are not high-density or transit-oriented but each has a clearly defined sense of neighborhood even though income levels for each area vary. They were built by builders and lacked the complexity associated with modern new urbanism. Such complexity (as they have in terms of fine grain of land use) has occurred over time.





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trend is toward even smaller households in the future. While developers are continuing to build four-bedroom houses in the Portland area for instance, Metro projections are showing the aging of households and shrinking household size. These trends suggest that the preponderance of households formed between 1995 and 2015—on an average basis—will consist of two persons or less.

The demographic trend of lowering household size occurred last in the pre-World War II period. The current development and land use trends to which we are accustomed are post-war and need to be re-evaluated on an economic basis because the demographics which underlay them are gone. There is a serious need to re-evaluate market studies and appraisals based on past trends.

Appraisal Guidelines Which Model Externalities

One difficulty with appraisals of Smart Development subdivisions is that the appraisals focus on the housing product and do not account for the long-term economic value produced by higher quality infrastructure, adjacent amenities, pedestrian amenities, access to transit and other features of Smart Development. The reason for this is that market studies and appraisals typically compare only products (i.e., the housing unit), and then place those products figuratively speaking within the context of their neighbors and allot them the value that they would have in the adjoining subdivision.

The fact is, however, that Smart Development features are positive attributes which have long-term effects on value. These effects on value are called externalities by economists and there are ways to gauge the impact of externalities and apply them to new development to understand the real value created. Such a process needs research to be undertaken but such research is well within the professional purview of the appraisal community. Appraisal is regularly performed involving regression equations to model economic value (most notably in taxation where people are less likely to cooperate) and could be applied to this area to help produce new standard rules of thumb for evaluation of Smart Development.

Further Collection and Presentation of Successful Projects

The last solution to the appraisal and market study obstacle to Smart Development will be to continue with the collection of national examples of the new building trends. For the State of Oregon, this is the least satisfactory option as it simply relies on the same model of providing past trends while the current growth situation in Oregon needs pro-active development practice.





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Provide Assistance with Lending Approval Process in Absence of Local Comparables

Just as small developers may not have the financial resources or business background necessary for business planning, few have the expertise necessary to demonstrate new demographic markets in the absence of comparable projects appealing to those markets. This lack of comparables as discussed above is an obstacle in the loan process. One way of overcoming this obstacle would be for the Smart Development program to offer local market assistance to show the demographic support locally for Smart Development.

As outlined by one banker surveyed, this process would involve the following steps. New demographic trends and target demographic markets would be delineated. These demographic groups would be segmented by income and ability to buy or rent the product under discussion. Next, representative random surveys within the targeted and qualified buyer groups would be taken to gauge market acceptance of the pricing and concepts, and finally focus groups would be undertaken to fine tune concepts and understand willingness to buy.

Such a set of studies would benefit the lender by providing concrete evidence of emerging market trends that support Smart Development.

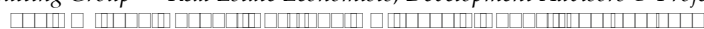


Infrastructure Cost Shifting to Compensate for Congestion Relief

At one time, developers did not pay for streets. In many western cities formed around the railroad, when the grids were laid out, streets were built by the city and housing builders filled in with houses. In post-war America, cities stopped providing streets; over time, the emphasis shifted to developer provision of infrastructure.

As this occurred, housing had to subsidize local streets while the major public infrastructure dollars were taken from cities through federal and state taxation and funneled back through large regional infrastructure improvements (freeways) which sped development in fringe areas. In most U.S. states, the words "Transportation Department" are a euphemism for what started as—and remains—the state highway department.

We now know that highways and major arterials do not necessarily eliminate congestion, but rather, can act as a subsidy for congestion-producing development patterns. That is, no matter how many lanes are added they are immediately filled to a capacity which matches the commuter tolerance for congestion. Congestion is best reduced by fine grained land use (which allows short trips) set within a network which allows alternate routes and transportation modes to any given destination.





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Transportation Departments should consider the value to the public of limiting expenditures on regional improvements in favor of local improvements that would establish fine grain network street systems, such as grids—which are currently difficult for individual small developments to finance. Small developers would then be able to provide the pedestrian amenities desired and provide more affordable Smart Development. The up-front costs of infrastructure are a major obstacle to Smart Development and a change in funding emphasis by state and federal agencies would not be inappropriate in helping to solve this problem.

Credit Enhancements or Tax Abatements in Exchange for Social Goals

Because of the competitive nature of current development markets, socially-mandated density and affordability targets are not possible to achieve without some form of subsidy. Further, demands for grid streets, pedestrian amenities, street landscaping strips with trees (at the same time as demands for high quality construction enforced by codes) make development either unaffordable or financially infeasible.

We often forget in looking backward that while old neighborhoods may have had cachet, they also had what we would now consider substandard utilities, substandard insulation and fire protection, substandard electrical work, no appliances, inefficient heating, etc. The fact is that standards are higher than ever before for all phases of construction, and consumer expectations would not be met by a 1905 unit *as it was constructed and sold in 1905*.

If the goals of Smart Development are serious social goals, then some level of first phase credit enhancement in exchange for fulfillment of social goals is not inappropriate. Such credit enhancement would serve to produce land use and development that will ultimately provide long-term benefit and lowering of social cost by reduction of congestion, auto use and by increase in quality of life.

This report was prepared by Edward Starkie of Leland Consulting Group, Portland Oregon. Mr. Starkie has an extensive background in the real estate industry and has served as a project manager for site planning, development, construction cost control, approval processes, housing feasibility, housing post-construction litigation and related issues. His experience and research abilities have been extended by a mid-career Master of Science in Real Estate Development from the Massachusetts Institute of Technology. Recent assignments have focused on light rail, mixed-use development and neotraditional development. He can be reached by e-mail at: pounder@teleport.com.

Leland Consulting Group provides research and advisory services for economic development planning, implementing major real estate projects and due diligence for business acquisitions. The Group specializes in enhancing opportunities and solving problems. Because of extensive cross-training in research, analysis and development, principals of the firm bring a high level of practical experience to their assignments. We assist our clients by reducing risk and adding value. This is accomplished by focusing projects to their market, working closely with planners, architects and owners to formulate creative development plans and following through on implementation and operations.

