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# Financing New Urbanism Projects: Obstacles and Solutions

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## *Abstract*

A survey of 23 industry practitioners from the development and finance fields yields a number of important conclusions regarding the financing of New Urbanism projects. First, these projects are perceived as generally riskier than typical real estate projects; their multiple-use nature is the basis of that perception. For urban infill projects, the perceived risk is low, while for suburban projects, the perceived risk is high.

The relatively high perceived risk for most New Urbanism projects imposes relatively high required rates of return, which in turn require these projects to generate cash flow quickly to be financially attractive to investors. In addition, the development of multiple uses—or multiple product types—in a single project is viewed as inherently more difficult to evaluate and implement. Financiers consequently favor larger, more experienced developers for multiple-use projects in general and New Urbanism projects in particular.

**Keywords:** Development/revitalization; Land use/zoning; Real estate

## Introduction

The Congress for the New Urbanism (CNU) commissioned the Zell/Lurie Real Estate Center at the Wharton School of the University of Pennsylvania to conduct research to determine whether lending and investment practices make it especially difficult for New Urbanism (NU) developments to obtain financing. A review of the literature suggests that, while much has been written about the NU concept (also referred to as traditional neighborhood development, neotraditional development, and smart growth), very little has been written about the financing of these projects. To garner a cross-section of opinion from the real estate industry, a list of 55 leading developers, lenders, and equity investors was compiled. The list included, but was not restricted to, those who had direct experience with NU projects.

A total of 23 people (developers, financiers, and investors) responded to a survey and agreed to be interviewed. Of that number, 22 were familiar with the NU concept, and 18 indicated that they had experience with NU or similar projects. The survey took the form of a questionnaire and a telephone interview. (The questionnaire that was the basis of the phone conversations is found in the appendix.) While all

respondents were promised confidentiality, table 1 provides brief descriptions of each. Of course, 23 data points are hardly sufficient to lend statistically significant validity to our conclusions, but the survey nevertheless provided 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). In addition, we reviewed how the current policies and practices of Fannie Mae and Freddie Mac affect NU financing. Finally, we surveyed the files of the Urban Land Institute (ULI) for case studies on NU projects specifically and multiple-use projects in general.

The main body of this article reports and analyzes the responses to the telephone survey. We focus on the responses to a series of questions asked to elicit the beliefs and motivations of those who build and finance NU projects. More precisely, we inquired whether multiple-use projects in general, and NU projects in particular, are perceived to be inherently riskier or more costly. The answer is yes on both counts, with the perception of higher risk being more important in terms of its impact on financing. The linkage between multiple use and NU seems significant to us, for although some NU projects with a single use—residential—have been realized, the stated aim of NU is to provide housing in proximity to retail and commercial uses.

We then analyzed why NU projects are perceived as riskier, thereby requiring more expensive financing. It is noteworthy that financiers perceive the higher risk as arising from the multiple-use nature of the developments, not just from their NU features (higher density, smaller lots, novel housing products, etc.). The multiple-use nature of the projects is the basis of perceived risk, with risk premiums of varying sizes being added for different locations and types of NU developments. Multiple uses add a layer of complexity that many financiers found difficult to evaluate for a variety of reasons. Increased uncertainty raises risk and required returns for investors and lenders. According to our respondents, the risk associated with NU itself appears to vary by the type of project. The added risk premium for urban infill NU developments can be quite small for projects where there is little doubt about the willingness of existing communities to accept high densities. The perceived risk of suburban NU developments, however, is greater, and it is highest for suburban greenfield projects.

Higher perceived risks lead to higher required rates of return, which put pressure on NU developments to generate cash flow quickly. This is difficult to do in large, complex multiple-use deals, and unless there is a patient financing source such as a pension fund or an endowment, this can be a major problem. And, further, unless the very nature of traditional bank lenders, opportunity funds, or other investors in the capital markets changes, the problem is not likely to go away unless perceived risk falls.

*Table 1.* **Description of Survey Respondents**

1. Director of development and leasing, real estate investment trust (REIT)
   - Headquartered in the southern United States
   - Familiar with NU
   - Experience with NU

2. Developer and home builder
   - Operates in Pennsylvania
   - Familiar with NU
   - Experience with NU

3. Owner/developer
   - Operates in North Carolina
   - Familiar with NU
   - Experience with NU

4. Managing director and director of research, international capital management firm
   - Headquartered in Chicago
   - Familiar with NU
   - No experience with NU

5. Developer
   - Operating primarily in California
   - Familiar with NU
   - Experience with NU

6. Developer
   - National firm, operating primarily in the southwestern states
   - Familiar with NU
   - Experience with NU

7. Investment banker
   - International firm headquartered in New York City
   - Not familiar with NU
   - No experience with NU

8. Senior managing director, property development, REIT
   - International operations, headquartered in Chicago
   - Familiar with NU
   - No experience with NU

9. Director of land acquisition, international capital management firm
   - Headquartered in Chicago
   - Familiar with NU
   - Experience with NU

10. Investors in urban development
    - Headquartered in New York City
    - Familiar with NU
    - Experience with NU

11. Developer of affordable housing
    - Operates in the New York City environs
    - Familiar with NU
    - Experience with NU

*Table 1.* **Description of Survey Respondents** *(continued)*

12. Developer
    - Operates in Florida
    - Familiar with NU
    - Experience with NU

13. Developer
    - Operates in California
    - Familiar with NU
    - Experience with NU

14. Developer
    - Operates in Tennessee
    - Familiar with NU
    - Experience with NU

15. Managing director, real estate development fund
    - Operates in the southeastern states
    - Familiar with NU
    - Experience with NU

16. Developer
    - Operates primarily in southern California
    - Familiar with NU
    - Experience with NU

17. Managing director, international investment banking firm
    - Headquartered in New York City
    - Familiar with NU
    - Experience with NU

18. Manager, operates private family investment trust
    - Active primarily in Hawaii
    - Familiar with NU
    - No experience with NU

19. Developer
    - Active primarily in Oregon
    - Familiar with NU
    - Experience with NU

20. Developer
    - Active primarily in the southwestern states
    - Familiar with NU
    - Experience with NU

21. Residential owner/developer, national firm
    - Headquartered in Georgia
    - Familiar with NU
    - No experience with NU

22. Residential developer
    - Active primarily in Pennsylvania
    - Familiar with NU
    - Experience with NU

*Table 1.* **Description of Survey Respondents** *(continued)*

| |
|---|
| 23. Investor, owner/developer<br>• Headquartered in New York City<br>• Familiar with NU<br>• Experience with NU |

The higher perceived risk of these projects has other important implications for NU developers. Because higher required rates of return necessitate quick generation of cash flow, carefully planned phasing is needed, especially for larger, more complex projects. For this and other reasons, the financiers we interviewed favored large, experienced development firms for such projects. They expressed the belief that there was better management quality—both financially and at the project level—in such firms.

We also focus on the differences in financing NU on suburban greenfield sites versus urban infill sites. In this case, the lender/investor community was adamant that suburban greenfield sites were much riskier—so much so that many would not even consider investing in them. The difficulties of dealing with large up-front infrastructure costs and with making large-scale retail work in projects without an established population base were mentioned repeatedly. The hostility of many private sector capital sources to suburban greenfield NU projects suggests that the future of these developments may lie in some type of intervention from the public sector (i.e., some type of guarantee or credit enhancement). Any sound economic argument for such public sector intervention will have to rest on these projects' having a social benefit that is not obtained by standard suburban development.

Finally, we delve into the impact of entitlements on the financing environment. All the respondents agreed that proper entitlements were necessary to obtain financial commitments. Some California developers observed that entitlements for relatively high-density development could be a problem in communities where such development is a novelty. However, the general feeling among respondents, most of whom had direct experience with NU, was that these developments were not inherently more difficult to entitle than other projects; some respondents even felt that entitlement for urban infill sites was easier if multiple uses were involved. This does not correspond to the views expressed by some of the founders of the CNU (Calthorpe 1993; Duany, Plater-Zyberk, and Speck 2000). The explanation for this difference may result from individual experiences with NU development among our respondents, or it may be that proponents of NU overstate the entitlements issue.

## Major issues and findings

### *Review of the literature*

We did not identify any academic studies that directly address the subject of financing NU projects. Two of the most prominent NU proponents and practitioners, Leinberger and Davis (1999), have recently written a provocative piece on financing these projects, and we will return to their work later. However, most of the literature is in popular or industry journals and does not offer a systematic analysis of issues such as consumer demand, economic advantages and disadvantages, and costs and benefits of different development approaches. There is much anecdotal and impressionistic argument on both sides of the issue. Clearly, more objective studies are required. What follows is a brief overview.

Volk and Zimmerman (1998) compare the advantages of NU communities with conventional master-planned communities and challenge the common perception that NU communities require heavy up-front costs. Winburn (1992) presents a somewhat different view of NU first-phase infrastructure costs and compares developing a specific NU community with a conventional planned unit development. He maintains that the disadvantage of developing against the grain resulted in over a year's worth of interest payments, as well as increased legal and design fees.

Bookout (1992b) suggests that the support of regulators and lenders, while important, is only one ingredient in the successful implementation of an NU development and that ultimately the market's demand for these communities will determine the success of the concept. Canty (1995) agrees with Bookout on this issue.

Schleimer (1995) claims that many NU projects have fallen short of their expected success despite all the media attention. He argues that the NU movement needs a highly profitable project to negate the real estate industry's suspicion that these communities are too costly and not marketable. He then briefly discusses sales and profitability for several NU developments, including Harbor Town (TN), Laguna West (CA), and Pacific Northwest (OR), and maintains that many NU projects are unprofitable because of insufficient market research, problems in phasing "parcel releases," and slow introduction of key community amenities such as retail. He points out that in Kentlands (MD), homes were priced at $138 per square foot, compared with $105 per square foot in competing subdivisions. Kentlands' higher house prices are the subject of another research study that reaches a different conclusion: that home buyers pay a $5,000 to $30,000 premium to live in an NU community, indicating a consumer preference for features such as walkability (Eppli and Tu 1999).

Although there have been few market studies on consumer demand for NU developments, a 1989 study does provide some insight into this issue. A survey of more than 2,000 prospective home buyers from the western and southern United States demonstrates that only 34 percent of respondents preferred mixed-product neighborhoods to communities where expensive homes are separated from less expensive ones and different uses such as retail remain separated (Farnsworth 1998). A survey conducted in 1995 by American LIVES suggests that although two-thirds of the respondents were dissatisfied with conventional master-planned communities, only 21 percent embraced NU concepts (Rybczynski 1998).

According to Bookout (1992b), overcoming lending standards can be especially problematic for the retail and commercial components of an NU development, particularly with respect to small-scale retail. Fulton (1996) echoes Bookout's concern for NU's economic feasibility: "The traditional neighborhoods that the New Urbanists hope to replicate are characterized by compactness, small scale and diversity of buildings. But, increasingly, the economic and lifestyle demands of urban and suburban life seem to require facilities on a massive scale" (26). Bookout (1992a) believes that the real obstacle to NU projects is not with development regulations and approval bureaucracies, but with project financing. Starkie and Yosick (1996) argue that many lenders and developers do not understand the markets, values, and risks inherent in NU projects and assert that the anxiety of real estate development lenders stems from Fannie Mae's "pass through" requirement, which holds the bank responsible for a project through foreclosure of the asset.

According to Leinberger (1998), the segmentation of the real estate industry is an obstacle to financing NU developments. Dinsmore (1998) maintains that this trend toward market segmentation is compounded by the rise of real estate investment trusts (REITs), which have emerged as major owners of real estate and as the chief real estate investment vehicle for pension funds and insurance companies. Like development companies and most lenders, REITs focus on investing in a single type and class of building. An NU project financier writes that packaging real estate investments so that they can be bought and sold on Wall Street strongly favors product standardization (Chapman 1998).

## *The relative cost and risk of New Urbanist projects*

Our survey focused on issues surrounding the financing of New Urbanist projects. As table 1 indicates, a wide array of builders, lenders, and investors with familiarity or direct experience with NU projects were interviewed. The results show near-unanimous agreement that NU projects are more costly than single-purpose or single-product type

developments (scale-adjusted, of course). Building at a higher density is itself more costly. While some savings can be associated with features such as smaller lots, multiple uses or multiple types of a given product (e.g., apartments, detached houses, and row houses) mean that the economies of scale associated with mass-producing a commodity often cannot be realized. A number of developers also note that the nonstandard nature of many multiple-use developments means that the well-known engineering practices used in, say, suburban tract housing cannot be applied. Greenfield developments are also considered more expensive since the infrastructure investment required by NU projects (e.g., rear lanes) is more elaborate than that associated with standard plat housing on the urban fringe. Nevertheless, few respondents believe the extra costs associated with NU to be much above 10 percent of overall project value, and some believe them to be less. In addition, neither equity investors nor lenders perceive this to be a major obstacle to the financing of well-conceived NU projects.

Much more important for the availability and cost of financing for NU projects is their higher perceived risk. The lender/investor respondents were unanimous in their belief that the complexity of developing and meshing multiple uses raises the risk level; the developers generally agreed. We note that this risk factor is due to the multiple uses involved, not to the NU nature of the projects per se. Complexity generally raises risk and not just in real estate development. Complexity also tends to make each project relatively unique, and lenders and investors generally attach significant return premiums to nonstandard investments. Many financiers also emphasized that it is difficult to accurately predict the demand for projects with multiple property types—whether there are New Urbanist features involved or not. In addition, most developers typically specialize in one product type. Large NU projects require superior management skills across a range of product types to properly phase the development of multiple uses in order to coordinate cash flows 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 in general, there are additional risk premiums specifically associated with NU projects. One derives from the concern expressed by some respondents about the depth of market demand for the NU product. This fear appears to be the least pronounced for urban infill developments, since there is much less doubt about the willingness of urbanites to accept higher densities and multiple uses in their neighborhoods. However, our respondents have a different perception for the suburbs, where public debate about higher densities (combined with NIMBY—not in my back yard—problems) can raise perceived risks of NU developments even after entitlements are received. These risks are 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 influence perceived risk.

In sum, the basis of perceived risk is the multiple-use nature of NU projects, with varying risk premiums added on for different types of developments. There was no financier on the debt side or the equity side who thought that these projects on average should have a required rate of return of less than 15 percent. Simpler urban infill sites with a predominant use might have a lesser required rate of return; presuming moderate leverage, suburban projects would require a higher rate of return.

### *The difficulty of financing NU projects*

Our survey results suggest that some lenders are prepared to finance a multiple-use project in its entirety, whether NU in nature or not. However, most of the lenders and investors interviewed noted that their policy was to categorize each property type separately, evaluating the overall project as a weighted average of the individual property types. One reason they did so 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 were generally skeptical of a typical developer's adeptness at building more than one property type. They claimed that there are relatively few developers with successful track records in multiple-use projects, a factor that motivated careful scrutiny of each property type. In addition, our financiers tend to be more comfortable lending against or investing in one product type per deal. The process of evaluation by property type does not necessarily mean that a NU project will have multiple financing sources, although that is what happens in many cases.

While our respondents felt that overall evaluation costs are generally higher for NU deals, the difference was modest compared with overall project value. The real onerousness of the financing environment for NU developers arises from the higher perceived risk associated with multiple-use projects in general and with the newness of the NU concept in particular. Higher risk leads to higher discount rates applied to cash flow. 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 effectively mean that cash flow in the longer term has little value to the typical lender or investor. Unless the project can generate enough cash flow in the early years, it will not be perceived as financially viable. Since the gestation period of large NU projects is mid- or long term,

that almost certainly is why many capital market participants will not finance them or will finance them only if assured that carefully planned phasing of the development will generate cash early in the project's life.

This need for good financial, as well as project-level, planning led several respondents, lenders as well as developers, to suggest that the complexity of large mixed-use projects, including NU projects, is best handled by correspondingly large organizations. Large organizations are perceived to have broader management resources and easier access to capital. In other words, large organizations lower the risk perceived by lenders. Conversely, our respondents from the financial community tend to believe that smaller, less experienced NU developers should work on smaller, simpler projects.

Our survey responses also indicate that a difference in return requirements, not a difference in project evaluation methodologies, is the most important way in which lenders vary in terms of financing NU projects. Banks, investment banks, and opportunity funds tend to have short-term investment horizons and impose relatively high rates of return on NU projects, with investment banks and opportunity funds tending to have the highest requirements. With an internal rate of return hurdle in the high teens, the discounted cash flow approach used by these financiers means that 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 for a variety of reasons. Some corporations and REITs, including Federal Realty Trust and Forrest City, have access to their own balance sheet to finance longer-term projects, some of them NU projects. Pension and endowment funds 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 for the reasons discussed earlier. 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 at the back end of long-term deals. A few developers have already discovered this, as is discussed more fully later.

### *Greenfield versus infill projects*

One of the striking conclusions from our survey is the very different attitudes of both debt and equity financiers toward greenfield versus

infill projects (whether urban or suburban). As noted earlier, NU developments in infill areas are viewed as relatively risky, but the general opinion is that well-done, multiple-use development can be profitable if (a) the payback period is short enough, (b) the site is acquired at below replacement cost, and/or (c) the project is focused on a dominant product type that the financier understands well.

Financing for greenfield NU developments is another case entirely. Basically, respondents from the lender and equity investor communities view the history of such projects unfavorably and believe that 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.) Our interviews found that the financial community is particularly skeptical that town center retail can be made to work in such settings. They claim 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 of respondents believed the carry cost associated with up-front infrastructure investment to be so large as to make the projects nonviable for all but large companies with access to internal capital. That is, if a town center had to be put in early, the subsidy required would kill the deal from their perspective. While some developers optimistically compared the up-front cost of a town center with traditional subsidized community amenities such as golf courses and clubhouses, there was general skepticism about extended subsidies to retail or commercial uses.

The unanimity and forcefulness with which these opinions are held by the capital market sources we interviewed lead us to question the viability of future private sector financing for suburban greenfield NU projects. If our conclusion is accurate, then we believe that for such projects to be done in even moderately large numbers, some type of public sector intervention will be required. This might take the form of partial financial guarantees or credit enhancements. A sound economic rationale for any such intervention and for the use of government resources requires that NU projects deliver a social benefit that does not arise from the typical master-planned community, for example. Such a benefit might take the form of lower pollution as a result of higher density, reduced time in traffic, and greater opportunities for walking. We do not know whether such benefits exist, since documenting them is well beyond the financial focus of this article. Our point is to emphasize that the justification for such a policy does not involve finance per se and that the CNU should consider conducting other research if it wishes to influence public policy in this area.

### *The entitlement issue*

All parties, both developers and capital sources, agreed that projects needed 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. The general feeling among developers is that it is not. 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 were a few comments that some communities without existing high-density development would fight hard against density, dramatically slowing the approval process. While this may be a problem for NU developments in traditional suburban areas, our respondents suggest that it is not an obstacle in urban infill areas or on the urban fringe. Many 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 were actually looked on in an increasingly favorable light by certain communities.

### *The role of Fannie Mae and the secondary market agencies*

Fannie Mae is by far the largest purchaser and securitizer of single-family mortgages in the nation (and the world). Freddie Mac is second. The added liquidity these secondary market agencies provide, and the 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 to 30 basis points lower than those on nonconforming loans because of the liquidity provided by Fannie Mae and Freddie Mae in the conforming loan markets.[1]

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, in our opinion, 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 nonresidential property types (i.e., commercial, retail) in the projects they fund. For example, to be eligible for Freddie Mac's Multifamily Streamlined Refinance Program, a project cannot have nonresidential rents exceeding 25 percent of effective gross revenue or have nonresidential tenants occupying more than 25 percent of the square footage of the improve-

[1] See Hendershott and Shilling (1989) for one of the first studies on this topic.

ments.[2] Fannie Mae's limits on nonresidential activity can be even more stringent. According to materials provided by Fannie Mae's Multifamily Management Team, there is a 20 percent limit on nonresidential square footage for all product types (including negotiated transactions). Fannie Mae also has restrictions on the fraction of project income that can arise from nonresidential rents.[3]

The chief reason for these restrictions is a charter that commits Fannie Mae to focus on the residential sector. That charter has been interpreted to mean that projects with substantial nonresidential components are not legitimate business targets. This effectively excludes most, but not all, NU projects.

In fact, Fannie Mae's charter is silent on precise limitations, so these percentages were presumably set by senior management. While we were not able to elicit any specific comment about this from Fannie Mae officials, we do not find it particularly difficult to understand their reasoning. Although wielding substantial political power in its own right, the organization 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. FM Watch, a well-funded watchdog group of private sector firms, was founded in 1999 to monitor the situation. Given the relatively small number of NU projects and the fact that retail and office developments are obviously not housing—even if done in conjunction with housing—it is probably not worth the added political risk for Fannie Mae to venture into this area. We conclude that any payoff from funding multiple-use or NU projects is highly unlikely to outweigh the political (and possibly financial) costs associated with the complaints that would certainly arise from Wall Street and insurance company originators and securitizers of commercial mortgages.

Although Fannie Mae has funded a small number of NU projects with overwhelming housing components (including two developed by people we interviewed), even if it entered the arena more actively, we suspect that the risks would not be viewed any differently from those described earlier. That is, relatively high interest rates would be charged to compensate for the relatively high risk of multiple-use projects generally and NU projects specifically.

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[2] These figures were obtained from Freddie Mac's Web site (<http://www.freddiemac.com>) and pertain to material dealing with the *Multifamily Streamlined Refinance Program* as of April 27, 1999.

[3] This information came from Fannie Mae's 1999 *Delegated Underwriting & Servicing Guide*, part III, section 202.03, Nonresidential (commercial) occupancy.

### *Strategies for dealing with the onerous financing environment*

One solution to the problems associated with higher perceived risk would be 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 without deposit insurance, the adoption in recent years of the discounted cash flow methodology, which is taught throughout the business and economics communities, reflects sound financial practice. And the simple 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 way.

Another more practical way for NU developers to ease their financing burden is by working harder at creating relationships with capital market players, such as pension funds and endowments, that often have lower requirements on return for their real estate investments. We were surprised that very few of the NU developers we interviewed had developed such relationships. This concept is not unknown to the development or Wall Street communities. In fact, Leinberger and Davis (1999) 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 returns. While this strikes us as a useful strategy that should be investigated by other NU developers, pension and endowment funds constitute a small fraction of total possible capital sources. Hence, the number of patient capital sources available to wait for their return in long-term projects is limited.

Accommodating capital sources with different investment horizons and return requirements also means 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 are needed on the developer side so that some component of the development is generating cash flow quickly. Even if a pension or endowment fund is willing to take most of its return of longer-term capital appreciation, the shorter-term needs of other capital sources must be accounted for—unless patient sources of capital are 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, preferably one that is recognized by institutions such as the ULI as standard. One respondent 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 that these spaces are multifamily 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 the all-in financing costs. This is a lesson NU developers need to learn even if it means altering their projects on the margin.

Finally, more and better historical data will help the financial community understand and better evaluate NU projects. It is important that such data be collected systematically. Lenders and investors already know the typical performance of standard ULI product types. The CNU should endeavor to make this the case for NU projects. If these developments do make money, documenting the fact should help lower the level of risk perceived by financiers.

One drawback is that many NU projects, which are relatively new, will not have available data spanning a full real estate cycle. To help deal with this issue, the CNU should consider a data collection and analysis project involving the multiple-use developments of various parts of the towns and cities that are conceptually similar to NU and began in the early 1900s. Such a project might yield useful information on long-run economic performance over many real estate cycles and could help investors and lenders more accurately gauge the real risk of this type of project.

The need for data collection and analysis is reinforced by the fact that we found no capital market source inherently hostile to the NU concept (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 ensuring 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.

## *Appendix*

## *Financing New Urbanism*

Questionnaire
The Zell/Lurie Real Estate Center at Wharton

The Congress for the New Urbanism has commissioned the Zell/Lurie Real Estate Center at Wharton to conduct a research study to determine if lending and investment practices make it difficult for New Urbanism developments to obtain funding. We are especially interested in whether lending practices vary by geography, asset type, and type of financial institution.

New Urbanism (NU), and associated practices such as traditional neighborhood development (TND), neotraditional development, Smart Growth, and walkable communities, refer to residential developments that are planned to be compact, diverse, mixed-use neighborhoods, appropriately scaled for pedestrians, and including many of the activities of daily living within walking distance of homes.

**QUESTIONS**

1. Have you read about, visited, developed, or funded a project with New Urbanism characteristics?

2. How would you rate your level of experience with such projects on a scale of 1–5, with a 1 indicating no experience and a 5 indicating a high level of experience?

The following two questions pose hypothetical mixed-use developments and ask you to evaluate financing risks.

3. A developer with a greenfield site seeks to create a mixed-use neighborhood that includes a retail core, office space, higher-density rental housing, and mixed density ownership housing.

   a. Based on your experience or knowledge, how much more difficult is it for the developer to arrange financing because of the mixed-use character of the project? For example, will the developer face four different reviews for each property type and four different evaluations of risk, the sum of which may be greater than the whole?
   b. Would you fund or invest in the entire deal? Would you be more likely to take on one piece of the deal?
   c. In your experience, would such a project have higher up-front costs, reducing returns and justifying different investment standards? Would such a project be riskier, because untested in the marketplace?

d. In your experience, would entitlements likely be an obstacle?

4. A developer with an infill site seeks to develop a mixed-use building with for-sale condominiums over retail shops within an existing mixed-use neighborhood.

   a. Based on your experience or knowledge, how much more difficult is it for the developer to arrange financing because of the mixed-use character of the building? For example, will the developer face two different reviews for each property type and two different evaluations of risk, the sum of which may be greater than the whole?
   b. Would you fund or invest in the entire deal? Would you be more likely to take on one piece of the deal?
   c. In your experience, would such a project have higher up-front costs, reducing returns and justifying different investment standards?
   d. Would such a project be riskier, because untested in the marketplace?
   e. Would entitlements be an obstacle?

5. How can the financing process work better for such projects?

   a. What can developers do to improve the process?

   b. What can the lending/investment community do to improve the process?

Please identify yourself. Individual information and responses will be kept strictly confidential.

Name: ______________________ Company: ______________________

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