Congress for the New Urbanism

Financing the New Urbanism

Summary of a Study Prepared by The Wharton School of the University of Pennsylvania

Over the past ten years there has been an increasing interest in new development models that are often referred to as "smart growth" or "New Urbanism." A survey conducted by New Urban News in 1999 reported that there were more than 125 new neighborhoods and 150 new infill projects under development based on the principles of the New Urbanism. As more developers pursue New Urbanist projects, the Congress for the New Urbanism (CNU) has become aware that many developers believe they face significant obstacles in obtaining financing for their projects.

Commercial banks and other institutional players categorize real estate projects into specific types based on their layout and intended use. CNU is concerned that these conventional practices could place New Urbanist projects, which do not conform to single-use, standardized layouts, at a competitive disadvantage and could limit the growth of New Urbanist development. To examine this issue, CNU commissioned the Zell/Lurie Real Estate Center of the Wharton Business School at the University of Pennsylvania to determine how real estate lenders and investors view the investment climate for New Urbanist projects.

The perceptions of lenders, investors, and developers were studied by interviewing members of each group. The study is thus a report of their opinions and experiences, and is not a statistic-based research effort. The Wharton study posed several scenarios to the real estate professionals. For each of these scenarios—an infill project in a mixed-use, urban setting, a mixed-use project in an established suburb, and a mixed-use neighborhood in a greenfield (new growth) location—the researchers sought to obtain an overall impression of the investment climate.

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Not surprisingly, the study's general finding is that the ability to finance a particular project depends on a host of factors. The major findings are summarized below:

Good Projects Get Financing

Repeatedly, the survey respondents note that "good" projects—those with a proven market, an experienced developer and a sensible phasing plan—were able to obtain financing. These projects include mixed-use projects (multiple uses within a single building or complex) and New Urbanist projects (multiple uses in a compact, pedestrian-oriented neighborhood). The respondents say that mixed-use projects are more difficult to finance than single-use projects and that, even for good projects, increased complexity is likely to increase the cost of project financing.

The Perception of Project Viability Depends on Project Location

Most of the other survey findings are related to the location of the project. In general, the respondents report that infill projects in urban location are the easiest and, therefore, the most cost-effective, to finance. They consider mixed-use and New Urbanist projects in new-growth, greenfield locations the most risky and, therefore, the most expensive.

1. Urban Infill Projects

The real estate professionals express the highest support for mixed-use buildings in urban settings. While noting that these projects can be complex and costly, they report that they are a known quantity in most markets. Other factors noted by the respondents that reduce the perceived risk of these projects include:

- Urban governments are often supportive of new development as a way to increase the local tax base.
- There are usually comparables that allow lenders and investors to accurately gauge risk.
- There is a significant number of established, experienced developers working in urban neighborhoods.

2. Suburban Infill Projects

Suburban projects consist of higher-density, mixed-use projects located within an existing suburb or immediately adjacent to an established community. Interview respondents have a number of concerns with these projects that lead to higher risk premiums and, therefore, more costly financing. Among the concerns reported in the study are:

- Limited comparables and a concern about the unique nature of the projects.
- Concern about neighborhood opposition to higher densities or mixed-uses.
- Concern that the buyers and renters in suburban markets not may desire higher densities or pedestrian orientation.

Despite these concerns, the respondents agree that good projects with solid developers can obtain financing.

3. Greenfield Projects

Clearly, the real estate community is most concerned with higher density, mixed-use development in greenfield, or new growth, locations. Many respondents felt that these projects are not viable. Much of the concern appears to be related to several high-profile New Urbanist projects that reverted to lenders during the recession of the early 1990's. The lenders and investors state that the size of mixed-use town centers, their location at the center of neighborhoods and away from major roadways, and the timing of town center construction caused financial problems. As a result, the survey finds a strong negative reaction to greenfield projects that seek to provide both housing and retail.

Several respondents also feel that greenfield New Urbanist projects are best left to highly capitalized corporate developers with long-term financial horizons. This opinion seems to be a reaction to the numerous accounts of the trials and successes of Disney's Celebration, Florida project—a project with a very long-term investment horizon. Another concern is that, without a level policy environment, Smart Growth and New Urbanist projects are unable to compete with "cookie cutter" conventional developments.

Other Important Perceptions

The study reports several other important perceptions held by the interviewees:

- Entitlements are not considered a significant obstacle to mixed-use or New Urbanist projects. In fact, many respondents consider New Urbanism's emphasis on pedestrian-orientation and high quality public spaces to be a benefit during the entitlement process.
- Fannie Mae and Freddie Mac are not likely to become a major source of capital for mixed-use projects due their emphasis on residential development.
- Investors and lenders report that they need more information about project performance so that they can gauge risks and benefits more accurately.
- Complex mixed-use buildings and New Urbanist projects with emphasis on high quality public spaces are believed to be 10% more expensive to build than conventional projects. However, this perceived cost is outweighed by the potential for higher sale and rental prices in New Urbanist communities.

Recommendations and Next Steps

CNU also asked the researchers to develop a series of recommendations for overcoming the perceptions and improve a project's chance for obtaining financing. These recommendations include the following:

- Developers can improve their chances of obtaining financing by building solid track records and by conducting accurate market studies that address the concerns expressed by the survey respondents.
- Developers should be prepared to phase projects to meet projected demand. Phasing must also match investor expectations by producing sufficient cash flow to quickly satisfy higher rate of return requirements or by building significant value to satisfy investors with long-term investment horizons.
- Organizations such as the Congress for the New Urbanism must increase their efforts to gather accurate information on project costs and financial performance and must also increase their efforts to educate the real estate industry about the financial benefits of the New Urbanism.
- Organization such as the Congress for the New Urbanism and the Urban Land Institute should increase their educational efforts by to train experienced conventional developers in the techniques of New Urbanism.

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Conclusion

The Wharton study indicates that conventional lenders, investors, and developers base many of their opinions about New Urbanism on their familiarity with certain high-profile projects. It suggests that well conceived New Urbanist projects proposed by established developers can obtain financing at rates appropriate for the project's relative risk. It notes that conventional low-density, single-use suburban projects in new growth areas will have a financial advantage as long as zoning rules and development regulations favor such development.

Many current New Urbanist projects are already adapting to the demands of the financial community. For example, Town Centers are being located at the edge of neighborhoods on high-traffic roadways to draw from a larger market. In other projects, retail development is limited or phased in over time to allow demand to catch up to supply. Several projects have even brought in different funding sources with different investment horizons to finance various project components. Thus, as the movement matures the projects become more strategically adept.

The Wharton study is currently undergoing peer review and is expected to be published in the Summer of 2000.

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