

Commercial Mortgage Insight[®]

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If The Lender Is Willing, Mixed-Use Is Still A Winner

Developers, cities, governmental agencies and consumers remain enthusiastic about mixed-use, although wary financiers may balk at the frequently sky-high price tags on these projects.

BY JESSICA LILLIAN

In February of this year, talk of mixed-use projects dominated most developers' accounts of their current and planned activities, and the disproportionate enthusiasm was reflected in the focus of the annual *CMI* Developers' Roundup.

At the time, we wondered whether all the interest represented a mere bandwagon-fueled trend or an indication of a fundamental shift in the family of traditionally accepted major asset classes. (See "Have Mixed-Use Developments And Lifestyle Centers Peaked?" in the February 2008 issue of *CMI*.)

Seven months later, it appears that if a saturation point for mixed-use developments exists, developers and communities have not yet reached it. Even as two dominant components of many mixed-use projects - retail and for-sale condominiums or houses - publicly struggle to varying degrees in many regions, these inclusive micro-communities continue to pop up all over the U.S.

"At the first of the year, you had the development community identifying and rallying around opportunities," recalls Steve Delson, president of DBN Development. "Mixed-use is a particularly desirable opportunity because it's often on infill sites that are underutilized within developed areas."



Steve Delson

He acknowledges that developers do sometimes latch onto buzzwords and competitors' activities - and may have forced mixed-use where it did not belong on more than one occasion, especially as the era of easy money allowed for such endeavors.

But with their unusual degree of complexity, mixed-use developments are a notably poor choice to initiate simply for the sake of capitalizing on a trend or following an architect's whims.

For instance, "We've seen people that were trying to put projects out in the very suburban Inland Empire - in communities that don't have the density or any kind of critical mass," Delson says.

Others placed retail and apartments in loose proximity to each other and called the area mixed-use - a move that Delson cautions could create the appearance of an over-saturated market and hurt the chances for a true mixed-use project in the area.

Suspect components

According to Neil Freeman, chairman and CEO of Aries Capital, lenders' on-the-books capacity for an individual deal generally tops out anywhere from \$20 million to \$40 million these days. Those limitations are unlikely to budge for the next 12 months or so.

Obtaining funding for a proposed \$200 million mixed-use development, for instance, thus poses a significant

challenge - unless lenders are willing to form partnerships to share risk.

"We've gotten a few deals done in the \$75 million to \$100 million range - where there are two or three participants and each one is taking anywhere from \$25 million to \$40 million," Freeman notes.

"But once you start getting beyond \$100 million, you need too many participants today," he adds. "People are having trouble getting those deals to work, even with good, quality projects."

Paul Braungart, founder and president of Regional Capital Group, reports that his firm still has a healthy appetite



Paul Braungart

for mixed-use. Like other lenders, the company - not surprisingly - prefers to fund projects with multifamily rental units rather than for-sale housing as their residential components.

As both the retail and condominium sectors have garnered a great deal of negative attention lately, developer and financier opinions vary regarding which project element is truly the weakest link in a proposed mixed-use development.



Neil Freeman

Condo components have stalled developers' plans for several recent projects, says Braungart. Many of those firms are seeking to convert the units to apartments if project economics allow them to do so.

Meanwhile, persistently negative findings on consumer spending and retailer bankruptcies continue to weaken retail's image and its potential perceived positive contribution to a mixed-use development.

According to Braungart, retail is undoubtedly weaker than rental apartments, but stronger than condos. "There has been some pushback in new [retail] tenants moving into facilities, but in a mixed-use type of situation, you're typically dealing with a more localized retail use," he says, adding that Regional Capital Group has seen no pullback from retailers in its own recent deals.

Despite both sectors' shakiness and a probable recession, difficult financial times may also serve to further the appeal of mixed-use for budget-minded consumers. For example, "Certain dynamics of the economy - like high gas prices - are going to make people more conscious of wanting to reduce their commutes and [encourage] transit-oriented developments," Delson predicts.

Similarly, the single-family housing market's decline may steer would-be and displaced homeowners into apartment units, such as those found in mixed-use communities.

For developers considering incorporating office pieces into their mixed-use plans, Freeman warns that in many markets - particularly suburban areas - this sector has been hit hard recently.

A hotel component is also a risky bet these days. Many existing hospital-
ity properties have reported solid rates, but occupancies in some markets have started to noticeably dip, he adds. The watch-and-wait mentality has taken hold in the hospital-ity realm, and many market players are paying particularly close attention to existing pipelines of new development in this sector.



Andrew Stewart

Regardless of the specific components of a proposed mixed-use development, developers should prepare for an uphill battle when seeking funding. "Because we're not in a greatly expanding economy, each component of every project will have to be proven," says Andrew Stewart, CEO of Cronheim Mortgage.

Consequently, every demand generator must be clearly shown. "If you can't, you're probably not going to finance it, and if you build it, you're probably going to build an unsuccessful project," he adds. Vacancies mean that tenants have more choices and that only truly quality developments - mixed-use or otherwise - will succeed.

The money question

Right now, the disruption of the flow of capital into development projects and difficulty in placing permanent loans on projects is causing assets to be repriced lower if no takeout loan can be obtained, Delson observes. Most life companies' available capital is now sent to existing assets rather than new development, and firms ostensibly willing to finance new projects - whether life companies or other balance-sheet lenders - have, of course, become extremely selective.

Aries Capital's Freeman believes the trepidation is reasonable. "I think lenders are being cautious on everything," he says. "They're being cautious on residential because that's where the biggest pain has been so far. They're being cautious on retail because the numbers are starting to suffer, and you're seeing some high-profile bankruptcies on some tenants. It hasn't been widespread yet, but everybody's watching."

Some frustrated mixed-use developers, however, find financiers' closed wallets and unreturned phone calls unjustified - particularly when their projects have been carefully sited and planned, with all unreasonably risky elements removed or modified.

"It's beyond caution, because cau-



100 Marketplace is a 57,600 square-foot mixed-use project located in Basking Ridge, N.J., and financed by David Cronheim Mortgage earlier this year. Photo courtesy of David Cronheim Mortgage.

tion implies that a rational process is going on, and then a decision is made," says Delson. "On the lender side, it's almost like the effort is to shut down the flow of projects in development - as if somehow that's going to correct the problem."

"The developers today seem to be paying for the sins of the past," he adds.

Fortunately for mixed-use developers, relief may be in sight for this sector before the rest of the commercial mortgage-seeking crowd. "Long term, I think demand for mixed-use environments of many types will dictate a substantial increase in the supply of that type of financing," Stewart predicts. He notes that the majority of the recent projects of this type have been extremely successful - inspiring confidence among lenders.

Moreover, Delson remains certain that the financing markets for mixed-use and beyond will shift to allow for Wall Street-based financing once again.

While the specific vehicle in place may change from commercial mortgage-backed securities (CMBS) to some to-be-seen variant, investors will crave the type of returns delivered by a mortgage security and reinstate the market in one form or another, he predicts.

CMBS will definitely return, Stewart agrees. "It is a proven asset class that has - even now - very low default rates and will prove, in the long

run, to be a part of every fixed-income investor's portfolio," he states.

Location, location ...

In the meantime, terms of the typical finance package for a mixed-use project generally follow the prevailing trends for any deal these days. Expect to find senior loans in the 60% to 70% leverage range, says Freeman, with the debt limit for some high-end projects around 50%.

"There are no 80-percent loans anymore," concurs Delson. "It puts a little more pressure on developers like us." He reports that mezzanine pieces have become increasingly vital for pumping up leverage, but its pricing - above that of standard construction debt - can make it an impractical or impossible choice in some cases.

Mezz providers themselves agree that this slice of the capital stack is not an instant cure-all for the current market's problems - and may become even less appealing in the months to come.

"The problem with mezz funds, including ours, is that there is not a lot of payoff," Freeman explains. "A year ago or two years ago, many people were paying off, so we have money to lend for new deals. Now, because financing is difficult, people are not paying the loans on old deals." Even if a bank's current portfolio is sound, the first priority must be working with existing borrowers to encourage an ample flow of money for new deals, he adds.

If mezzanine and equity prove unavailable or too expensive, new-market tax credits and historic tax credits might help fill in the gaps. Freeman reports some recent success stories with these options.

Although excess inventory among multiple asset classes plagues numerous U.S. locales, mixed-use success is based on individual regions and markets, Braungart stresses. "We're still finding pockets all over the country that are still vibrant and doing well," he notes.

Within those healthy pockets, a viable mixed-use development will naturally require a densely populated core and a demonstrated market need for each of its proposed components. Braungart suggests scrutinizing vacancy rates, existing retailer space and demand for rental space in particular.

Many of today's mixed-use projects are intended to enliven urban locales, upping the value of a previously underutilized and possibly blighted or crime-ridden space - and helping earn their developers a flattering public reputation for community improvement in the process.

At the same time, developers should avoid taking this undesirable-location trend to the extreme, says

Stewart. "It's hard to make a successful mixed-use development in a B location," he warns. "I don't see too many of them on really out-of-the-way blighted sites."

A high barrier to entry that virtually eliminates competition will likely also prove particularly helpful in proving the likelihood of success for a proposed mixed-use project, says Delson. Any other attributes - such as siting in a coastal community - should be immediately and thoroughly communicated to prospective lenders.

DBN Development's Radio Square project in Santa Barbara, Calif., for example, represents one of the last market-rate housing projects that will be built in the city, Delson notes. Even so, convincing financiers to agree that the project was sufficiently compelling proved difficult.

After all, he says, "This is one of those times in the economy - and we go through them periodically - where it's easier for people to say 'No' than to ask 'Why?'" ●



DBN Development recently completed final approvals for Radio Square, to be located in downtown Santa Barbara, Calif. The two- and three-story mixed-use development will include 32 residences built over and around 16,000 square feet of commercial space. Photo courtesy of DBN Development.