Structuring Urban Redevelopment Projects: Moving Participants Up the Learning Curve

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Abstract Urban redevelopment projects implemented through public-private partnerships are the preferred way to revitalize inner-city areas. As the numbers of participants increase and deal structures become more complex, participants need more detailed knowledge of one another's motivations and behaviors to achieve feasible redevelopment projects. This research describes the expectations and behaviors of private sources of debt and equity, especially their financial return requirements, and the actions public participants can take to reduce project risks. With this knowledge, lead public and private participants should be able to forge economically viable projects that generate greater public benefits while reducing the risks of urban redevelopment.

Introduction

For many years, metropolitan economic activity has been decentralizing, and central cities and inner-ring suburbs have lost employment and population relatively and often absolutely. Central city decline is associated with a host of social, economic and political problems. In response, public policy has favored the physical renewal and economic revitalization of inner-city areas. Urban redevelopment projects have been the favored vehicles for inner-city revitalization.

For the past several decades, mobilizing public-private partnerships has been the preferred approach to implement urban redevelopment. Local governments, community-based organizations, foundations, neighborhood groups and other community advocates represent the public. Real estate developers and investors, commercial bankers, and tenants or their brokers represent the private sector. The focus of these efforts has been finding ways to lower risks or increase returns to private participants in order to attract investment capital to redevelopment projects.

To secure private capital, the public participants have primarily sought ways to attract commercial lenders and other private sources of debt capital by lowering their financial risk. Since the late 1970s, the gap financing model has evolved to lower financial risk through subordinated financing, fixed and below-market interest rates, flexible repayment schedules, and guarantees or other forms of credit enhancement provided by socially-oriented lenders (Meeker, 1996; and Malizia, 1997). Less attention has been devoted to risk reduction intended to attract private equity capital. Although private and community-based real estate developers can provide some equity, they are rarely willing or able to fund the equity position fully. Furthermore, public policy has changed dramatically since the mid 1980s. Depreciation schedules, loss provisions, income tax rates and capital gains treatment have reduced significantly the tax-shelter benefits of real estate ownership. Tax credits for low-income housing, historic preservation and the New Markets initiative rely on the tax code to attract private equity to socially beneficial projects. In most instances, however, socially beneficial urban redevelopment projects must be both economically viable and financially feasible if private equity and debt are to be secured on reasonable terms.

The other major change since the 1980s has been greater project complexity. Urban redevelopment projects now involve more actors on both the public and private side. In many cities, the lead role of representing the community has shifted from the public sector to the non-profit sector, a change that has paralleled the growing importance of non-governmental organizations (NGOs) in international development. Community-based organizations, in particular, community development corporations (CDCs), have become the champions of public-private redevelopment projects. Community developers and planners participate on behalf of local elected officials that represent the public at large. Many CDCs bring local, regional or national foundations to the table with program-related investments, thereby broadening the base of available financial support. On the private side, real estate developers, local investors and commercial banks still participate as project leaders and as sources of equity and debt. However, they are often joined or replaced by other private actors that include commercial bank CDCs, specialized real estate investment trusts (REITs) and major tenants that assume an ownership position in the project. The simple deal structure involving private developer/owner, private lender and public source of financing has become much less common than deal structures that involve twice that many actors or even more.

As the group of participants grows larger and moves beyond the familiar ground of tax-credit housing or historic projects and becomes involved in more complex commercial ventures, it needs to move up the learning curve. Participants especially need more detailed knowledge of the current motivations and behaviors of private lenders and equity investors interested in commercial redevelopment projects (Porter, 1995; Carr, 1999; and Williams, 1999). With this knowledge, lead participants should be able to forge partnerships that generate greater public benefits while reducing the risks of urban redevelopment.

The research procedures and findings presented here are designed to increase the understanding of the expectations and behaviors of private investors, especially their financial return requirements. The next section reviews the research approach. The subsequent section summarizes the research hypotheses and findings.

The fourth section further elaborates on and draws implications from the results. The concluding section offers directions for future research.

Research Methods

Very little research has focused on the motivations, behaviors or return requirements of private actors financing redevelopment projects, especially equity investors. Adair, McGreal, Deddis and Hirst (1999) conducted research on the behaviors of private investors that participated in British redevelopment projects. Gyourko and Rybczynski (2000) surveyed investors to determine their expectations and investment criteria when financing new urbanism projects. Meyer and Lyons (2000) reported declining return requirements of private investors as they learned more about brownfield projects. Jackson (2001) surveyed private lenders and equity investors more systematically and found them increasingly able to gauge environmental risk.

The research approach evident in this literature involves primarily qualitative surveys based on convenience samples of participants. Why not take a more rigorous objective approach that would lead to descriptive or causal inferences? Why not randomly sample recently completed commercial redevelopment projects and their sponsors to gather the information? Four reasons justify the approach represented in the literature cited above and followed here. First, no practical, cost-effective way exists to identify the populations of investors, developers or lenders involved in urban redevelopment. Surveying projects, randomly selected or not, does not adequately represent the population of private participants. Individual investors are particularly difficult to find since most participate through third parties, like local attorneys, who operate via informal channels.

Second and more importantly, research focused on redevelopment projects intended to generate externally valid results would fail to be internally valid. More can be learned about private expectations, motivations and return requirements by taking account of the larger set of potential projects considered by investors than the ones they actually pursued. The only way to consider this larger set of realized or unrealized projects is to focus on the private investors and lenders themselves. This focus on participants is also more efficient because a much larger, more varied set of implemented and unimplemented projects can be considered. Therefore, the private participants themselves should be surveyed even if the samples are not fully representative.

Third, private participants responding to surveys have few reasons to provide accurate information about their actual motivations and behavior. Commercial bankers are well aware of CRA affirmative lending requirements and are not very interested in talking specifically about their motivations and lending criteria. Developers and investors have their money and reputations at stake. They have no incentive to be forthcoming with specific information about their investment practices that could expose them to criticism. In this context, private participants are motivated to provide general and vague responses instead of the clear and specific answers that are sought.

Finally, the specificity of the information sought largely determines the extent to which results can be generalized. For example, although real estate market analysts may want to know how many people will live in an area in five or ten years, demographers cannot provide such forecasts except with rather broad error ranges. Demographic and economic analysis can help market analysts understand whether an area is likely to grow or stagnate. In the context of this research, the hypothesis that investors require higher returns when they perceive higher risk can be tested empirically with expert surveys. But one should not try to generalize about the *level of return* required because general knowledge does not exist on this point. The level of return depends on the specific investor's risk tolerance, the specific project under consideration, alternative local and non-local investments opportunities, and the general state of capital markets. Similarly, the hypothesis that commercial lenders ration credit towards profitable, lower risk projects can be tested. But, the specific approach, underwriting criteria and financial ratios applied will vary with the project, the participants, the location and the timing of the project.

Research Strategy

How can specific and clear information be obtained from private participants? The researcher must have some reasonable entrée with them to get accurate information. Cold calls to private lenders and equity investors would not be worthwhile even if random samples could be drawn. The researcher must invest time in relationship building to generate the necessary trust. Direct discussions can lead to useful findings when respondents are comfortable with the researcher, the context and the uses of the research. Prior research suggests that properly oriented experts can offer thoughtful, accurate and honest information about the financing of redevelopment, New Urbanism or brownfield projects (Adair, McGreal, Deddis and Hirst 1999; Grourko and Rybczynski, 2000; and Jackson, 2001).

Three venues were used to gather and synthesize information on the research questions: (1) workshops with redevelopment project participants; (2) focus groups with these same expert sources; and (3) follow-up telephone interviews with some of these experts and with others who have not participated in redevelopment in low-wealth areas. In May 1999, a workshop was conducted in North Carolina for twenty-nine participants with experience in inner-city commercial redevelopment. In May 2001, another one was conducted in Virginia with a similar group of twenty-seven participants. The participants included real estate developers, commercial lenders, major tenant representatives, CDC directors, city planners and community developers, and community advocates, among others as shown in Exhibit 1. In the morning sessions, small groups with one participant from each

Exhibit 1 | Workshop Participants

North Carolina Participants, May 1999.

1. CDC executive directors: Greensboro, Charlotte, Rocky Mount, Durham and Wilson (5).
2. Community Development Department directors: Greensboro, Raleigh, Winston-Salem, Charlotte and Durham (5).
3. Commercial real estate developers—small scale speculative development in the southeast, headquartered in Chapel Hill, Raleigh, Greensboro and Charlotte (5).
4. Commercial leasing and tenant representation with clients in Durham, Raleigh and Greensboro (4).
5. Commercial bankers: Bank of America, BB&T, Centura Bank and First Union Bank (4).
6. Community development banking representatives (3).
7. Non-profit real estate developers including Wachovia Community Development Corporation (2).
8. Local attorney representing real estate investors (1).

Virginia Participants, May 2001.

1. CDC executive directors from Lynchburg, Norfolk and Richmond (4).
2. Community Development Department directors from Newport News, Norfolk, Richmond, Virginia Beach and state level administrators (6).
3. Commercial and residential real estate developers (4).
4. Non-profit real estate developers (2).
5. Commercial bankers: Bank of America, BB&T, First Union, Sun Trust and Wachovia (6).
6. Local Initiative Support Corporation (LISC) executive (2).
7. City manager.
8. Local city councilwoman.
9. Community development banking representative.

Overall Composition of Respondents ($N = 62$)

Private real estate developer: 16%
Commercial banker: 16%
Other private-sector representatives: 16%
Community development lenders and non-profit sector representatives: 16%
CDC executive director: 15%
Public-sector professionals or officials: 21%

of these groups were convened. Each group used the same case study of a hypothetical commercial redevelopment project to explore ways to increase private equity investment without diminishing the social benefits that the project was designed to realize (Malizia, 1999). After lunch, one representative of each group reported the group's solutions to all participants. In the afternoon sessions, four focus groups each representing real estate developers, commercial lenders, representatives of community-based CDCs or public sector professionals were convened. Each group considered a set of working hypotheses about urban redevelopment projects. The participants appeared to provide honest information in part because they had no financial or political capital at stake in responding to the questions.

Facilitators ran the morning and afternoon sessions, and note takers kept track of the discussion. The sessions were not tape-recorded, which increased the comfort level of the participants. Furthermore, individual responses were treated as confidential.

Telephone interviews were subsequently conducted with some of these participants. In addition, six real estate developers and investors that did not participate in urban redevelopment were identified and contacted. These interviews were used to clarify ambiguous points and to highlight important private-sector concerns. The draft report was written and circulated to all participants for final review and comment.

Although the research was conducted carefully and included checks to corroborate results, the research methods employed are qualitative and therefore suffer from inherent limitations. Group membership is highly selective, not representative. Workshop participants gained most of their recent experience in the southeast; most have not done projects outside of this region. Actual experience in urban redevelopment projects varied considerably, especially among the public participants. Still, over sixty participants expressed various opinions but ultimately were able to achieve near consensus on almost all issues. They generated specific results that have practical importance to the participants of urban redevelopment projects. Furthermore, the research pursued the important task of determining the views of private lenders and investors about participation in future redevelopment projects. (Since this research was largely completed before September 11, 2001 the potential impact of these events on urban redevelopment financing could not be assessed.)

Research Hypotheses and Results

The working hypotheses were formulated primarily from descriptions of actual public-private projects (for example, see publications of the Federal Reserve Banks' Community Affairs Offices), references on development finance used to train CDFIs personnel (for example, see Parzen and Kieschnick, 1992), and personal experience acquired through involvement in such projects (see Malizia, 1997; and Stainback, 2000). They address the related areas of valuation, development lending and development investing. In essence, the hypotheses apply and adapt the risk-reward framework to the domain of urban redevelopment projects. The results of this research add depth and specific content to generally accepted knowledge based on agreement among the participants.

Valuation

Hypothesis I. Risk is higher for redevelopment projects in distressed areas than for similar suburban development projects for three primary reasons: market risk is perceived to be higher in distressed areas than in the suburbs, the capital budget *is more difficult to estimate for redevelopment sites compared to greenfield sites and expectations of future conditions in central cities and core areas are more variable than expectations about suburban conditions.*

The participants easily accepted this hypothesis. The only contentious issue pertained to entitlement risk. One view was that entitlements were easier to achieve in the suburbs where procedures were simpler and compliance less costly. The other view, which was held by a majority of participants, was that entitlements were gained more easily in distressed areas ‘‘hungry’’ for growth compared to suburban areas that often had organized neighborhood opposition to further growth (NIMBY forces). Overall, project risk in distressed areas was still higher than in growing suburban areas because market risk and other types of risk were higher in spite of lower entitlement risk.

Hypothesis II. Real estate appraisers would apply higher capitalization rates to redevelopment projects compared to similar development projects in suburban areas to reflect higher risk.

Participants agreed with this hypothesis. They cited examples where they had used higher capitalization rates. They agreed that market analysts and appraisers use higher capitalization rates to reflect expectations of greater variance in future cash flows.

Hypothesis III. The selected market-determined capitalization rate should be consistent with the related yield capitalization rate. These rates can be used to relate current and expected market conditions to investors’ assessments of risk-adjusted returns.

By making assumptions about typical lending terms, one can derive a yield capitalization rate consistent with the overall capitalization rate (WACC approach). The participants did not follow this logic because they did not use appraisal methods in practice. Instead, they often used different measures of return and preferred either a simple cash-on-cash return analysis or discounted cash flow analysis to examine expected returns. Since real estate appraisers were not participants, no dialogue was possible on this hypothesis. It deserves further attention in future empirical research on this topic.

Development Lending

Commercial bankers and bankers representing community development financial institutions (CDFIs) were the main sources of informed opinion about these three hypotheses.

Hypothesis IV. Lenders apply lower loan-to-value ratios (or lower loan-to-cost ratios) when underwriting redevelopment projects compared to similar suburban development projects because lower leverage partly compensates for higher risk.

In theory, lenders are expected to ration credit. Rather than charge higher interest rates on riskier loans, they prefer to provide a lower proportion of the financing at the same interest rate as would be charged similar projects in other locations. See Wood and Wood (1985: 517–34) for a further discussion of credit rationing as a way to manage the overall risk level of loan portfolios. In practice, however, lenders prefer to achieve more conservative underwriting through credit rationing indirectly to avoid the charge of redlining. Lenders are not inclined to add risk premiums to capitalization rates that would lower project value solely on the basis of the project's location. Such geographically-based action, however justified, could be hard to defend and possibly raise questions of discriminatory lending. Instead of project value, the lenders agreed that they prefer to focus on the project's expected cash flow. In comparison to stronger projects, the redevelopment project's NOI estimates are likely to be lower and/or more variable. Higher debt-service coverage ratios are therefore warranted. These higher coverage ratios place limits on loan size. Proportionately smaller loans result in lower loan-to-value ratios or loan-to-cost ratios.

Hypothesis V. Lenders often lower market risk by requiring pre-lease agreements from credit anchor/major tenants or pre-sales to prospective residents. More conservative underwriting should result in debt coverage ratios that are comparable to or greater than ratios for suburban projects.

Participants agreed that lenders seek pre-leasing and strong credit tenants. They noted the greater difficulty of achieving these results in urban redevelopment projects. This outcome is another manifestation of greater market risk (Hypothesis I). Participants supported the logic of higher debt coverage ratios to provide more cushion for urban redevelopment projects during the critical early years of operation.

Hypothesis VI. Commercial lenders seek to lower risk by exercising effective control of urban redevelopment projects. They provide the required debt and can also offer the required equity through their CDC subsidiary to gain this control.

Participants soundly criticized this hypothesis and argued instead that lenders lower risk by lowering their exposure. They much prefer tapping multiple sources of debt and participating in loan pools to finance redevelopment projects. The lead lender can exercise adequate control without providing all of the needed financing. Therefore, the following proposition was substituted for the sixth hypothesis.

Commercial lenders seek to limit their exposure by involving other private and public sources of capital in project financing.

Development Investing

Hypothesis VII. Private investors consider redevelopment projects riskier than comparable suburban projects and therefore require higher returns.

Like the second hypothesis, participants readily agreed with this one. Urban redevelopment projects are definitely considered riskier than projects in growing areas.

Hypothesis VIII. Compared to suburban projects, private investors consider lower leverage on redevelopment projects, which lowers the lender's financial risk, as a disadvantage, since more equity is required. For any given amount of risk capital, more equity invested per project implies less diversification since fewer projects can be funded.

Commercial real estate developers said that available equity should be leveraged with available debt capital to own as many projects as possible. Spreading available equity over many projects lowers risk. Urban redevelopment projects are doubly less attractive from this perspective. They are individually more risky and collectively lead to less diversification.

Hypothesis IX. Private investors are as concerned about the return of capital as the return on capital in redevelopment projects and therefore seek clear exit strategies and ways to reduce their holding period.

Participating real estate developers argued that they develop an exit strategy before committing to redevelopment projects. They recognize that urban redevelopment projects are less liquid because their markets are thinner than ones in growing areas. They seek ways to reduce their holding period.

Hypothesis X. Private developers and investors sometimes sacrifice returns or assume greater risks because they identify with redevelopment projects. They receive non-pecuniary rewards instead.

Participants did not support this hypothesis. The public participants were particularly vocal in saying that redevelopment projects must ''pencil out'' before private developers and investors would consider them seriously.

Hypothesis XI. Community-based and social (foundation) sources of capital are often needed to complete the funding of redevelopment projects. These sources structure their participation primarily to attract private debt capital and secondarily to recapture value for the community.

Participants agreed that financing was an important aspect of public participation in public-private projects. Whether trying to secure private equity or applying the more traditional gap financing approach to attract private debt, these sources respond primarily to private participants. More recently, they have been asked to structure project financing to create opportunities for existing residents and community-based organizations to capture some of the value generated from urban redevelopment. Although a worthwhile goal, their priority remains on attracting private investors to implement redevelopment projects.

Elaboration

This section presents several additional insights offered about urban redevelopment projects from the private debt and equity perspective. Then, it offers strategies for public participants on the basis of private expectations and behaviors described in this section and in the previous one.

Private Expectations and Behaviors

Lenders and other sources of debt capital underwrite urban redevelopment projects more conservatively than suburban projects and commit less debt capital to these projects. In addition to lowering financial risk through more conservative underwriting, commercial lenders try to lower their financial exposure further by involving other private participants, including their CDC subsidiary. Although initially motivated by CRA, commercial bank CDCs have acquired the expertise needed to understand the strengths and weaknesses of commercial redevelopment projects and can identify economically viable ones. Commercial bank CDCs usually have the contacts needed to bring public and private financing sources together for redevelopment projects. For a related discussion of development lending, see Jackson (2001).

Commercial lenders cannot easily lower their exposure further because urban redevelopment projects are complex due to their uniqueness and multiple sources of financing. This complexity makes it difficult to tap secondary capital markets. Although secondary markets for tax-credit housing projects have existed for some time, such markets have been slow to develop for commercial projects. The Local Initiative Support Corporation's retail initiative (TRI) acts as a secondary market for certain commercial projects. Formed with the goal of investing in inner-city commercial real estate projects and backed by a number of strong financial institutions, Urban America, L.P. aspires to become an equity take-out for inner-city developments. Several REITs are also specializing in inner-city commercial projects and tapping secondary markets for equity capital. As the size and strength of inner-city markets become more apparent to investors, more such investment partnerships are likely to form and gradually build a secondary market for inner-city commercial equity and debt.

With respect to equity capital, investors consider the timing of equity infusions as important as the amount of equity required and holding period in determining return requirements. Unlike investments in fully leased properties, redevelopment requires funds before any space is available for lease. Risks associated with the pre-development period, the construction period and the lease-up period are relatively high and must be compensated with higher returns. For example, tax-credit investors who infuse equity late in the development process, after construction and substantial leasing have been completed, receive lower returns than those who invest earlier in the process. Developers try to finance front-end costs and cover the construction loan guarantee. When outside investors are asked to infuse equity during early stages of the project or provide the balance sheet that is used to guarantee the construction loan, their equity return requirements can escalate considerably.

Equity investors reduce their holding period and financial exposure through refinancing. If the redevelopment project is successful, it should generate more NOI and before-tax cash flow over time, which should increase project value. As debt service reduces the principal balance of the loan, equity builds in the project. Project owners can usually refinance the higher-valued project at a higher loan-to-value ratio than the ratio used for the original loan. As a result, the owners receive the portion of the refinancing left after the principal balance of the original loan is paid, which reduces their financial exposure both in amount and time period.

Strategies for Public Participants

Central city jurisdictions should try to lower perceived market and financial risk in inner-city neighborhoods to catalyze the redevelopment process. They should develop and steadfastly implement small-area revitalization plans, improve infrastructure selectively, increase project scale, cluster development around strong neighborhood anchors, use triage when necessary and promote competition. With respect to the first option, physical plans have always served as a framework to guide subsequent development. As a risk reduction technique, small-area planning is critical in order to reduce the number of alternative futures that could pertain to specific inner-city neighborhoods. Risks will not be decreased with visioning or general land-use proposals alone. The best plans identify which public improvements will be made, where they will be located and when they will become operational. Good graphics and visual representations of what the neighborhood could become are important ingredients in changing attitudes about places. Considerable political will is needed to implement specific small-area plans, but jurisdictions that reduce risk and uncertainty in this way should be rewarded with increased private investment. At the same time, local governments should pursue strategic land banking to help ensure that asking prices for land in locations earmarked for development do not skyrocket.

Second, although local politics usually results in resource allocations that spread funds among neighborhoods, small-scale public investments that are dispersed widely rarely reduce market risk. It is much more effective but politically difficult to concentrate resources in strategic locations and increase the size of projects in order to achieve adequate scale. Redevelopment resembles an invasion that must first establish a beachhead in one location before it can spread to adjacent land. Without adequate infrastructure and project scale, a beachhead cannot be established. With success in one area, redevelopment should gradually become self-sustaining as deals increase, information improves, confidence intervals narrow, risk goes down and values increase.

Third, certain areas may be too expensive to help, at least in the near-term, given limited resources and the need to focus public investments spatially to achieve adequate scale. In these areas, the objective should be to help existing residents and businesses find more viable locations. As harsh as this option may seem, private investors will come to understand that the public sector intends to ignore these areas for some period of time. Although asset values may decline, increased certainty about the future of these areas should narrow the range of alternative futures considerably. More certainty should provide a countervailing tendency that may eventually lift asset values in these areas.

Fourth, the public sector can promote competition among developers and investors if inner city markets, in fact, provide viable investment opportunities. Strategic public investments and specific plans should increase the attractiveness of specific sites and the value of property at locations where the market is strong. Currently, most redevelopment opportunities exist in ''buyers markets'' where private developers are scarce and are able to exact major concessions from the public in return for buying sites and investing in redevelopment projects. Local jurisdictions should try to make certain locations in inner-city areas sufficiently attractive to create ''sellers markets'' where private developers are lining up to buy or option sites in order to participate in the redevelopment process. This shift requires that local governments have been able to target their attention and resources on a few, key neighborhoods, rather than dispersing them throughout the entire city. The competition among private developers should drive up asset values, make redevelopment projects in the area more feasible, attract even more private investment and create opportunities to recapture appreciating property values for the benefit of the community. As more private capital flows to urban redevelopment projects, community residents should realize more local services, jobs, business opportunities and wealth creation.

All of these strategies are designed to reduce the uncertainty and risk involved in urban redevelopment. The most significant source of uncertainty is the wide range of informed and uninformed opinions that exist concerning the redevelopment potential of inner-city areas. Appraisers have difficulty valuing inner-city projects accurately due to thin markets (few transactions). The absence of good comparables increases the influence of opinions and other subjective factors. Existing property owners who derive income from current land uses have a vested interest in having an optimistic outlook on the long term. Developers may envision viable uses for such sites but only if the properties can be secured in the near term at reasonable prices. Investors usually have a wider range of assessments about risk and uncertainty than developers or property owners. Some investors are attracted to urban redevelopment projects whereas others have little interest in them. Because transactions are infrequent and projects are complex, markedly different investment outlooks may be justified for inner-city areas. Such differences of opinion form a major barrier to attracting the resources needed for redevelopment because they ultimately lower the value of potential projects. For elaboration, see Luscht, 1997, Ch. 14–15.) The research results are presented discursively in summary form in Exhibit 2.

Exhibit 2 | Summary of Results

- Public-private redevelopment projects that blend public and private sources of debt and equity capital are expected to be economically viable, socially beneficial and financially feasible.
- All development projects are exposed to risks that arise throughout the development process, especially entitlement risk, construction period risk and lease-up risk. Urban redevelopment projects face additional challenges that increase project risk.
- Risk is higher for urban redevelopment projects than for similar projects in growing suburban areas primarily for three reasons: market risk is perceived to be higher in inner-city areas than in the suburbs; the capital budget is more difficult to estimate for redevelopment sites compared to greenfield sites; and, most importantly, expectations of future conditions in inner-city areas and distressed neighborhoods are more variable than expectations of future suburban conditions.
- Real estate appraisers generally assign higher capitalization rates for proposed redevelopment projects to reflect uncertainties associated with expectations of greater variance in future cash flows.
- Redevelopment projects are more difficult to carry out than comparable suburban projects because they are often marginal: they are estimated to have lower economic value but relatively similar development costs.
- Lenders account for the higher risk of redevelopment projects compared to similar new development projects by underwriting these projects in ways that result in higher debt-service coverage ratios and/or lower loan-to-value ratios (or lower loan-to-cost ratios). More conservative underwriting is required to compensate for higher risk.
- Lenders seek to lower market and financial risk in three ways: by requiring pre-lease agreements from anchor tenants and other major credit tenants or pre-sales to prospective space users, by involving other sources of capital in redevelopment project financing and by calling on the expertise of their CDC subsidiary.
- Private investors consider urban redevelopment projects to be riskier than comparable new projects in stronger suburban areas and therefore require higher returns to compensate for higher risk.
- Private investors assess the return of capital as carefully as the return on capital and therefore seek clear exit strategies and ways to reduce their holding period. After income-generating projects have achieved stabilized operations, they can be refinanced or sold to return some or all of the capital to equity investors.
- Private investors consider lower leverage on urban redevelopment projects, which lowers the lender's financial risk, as a disadvantage, since proportionately more equity is required. For any given amount of risk capital, more equity invested per project implies less diversification because fewer projects can be funded.
- Because equity investors have relatively high cash-on-cash return requirements and lenders provide debt at relatively low loan-to-value ratios, the resulting capitalization rates for urban redevelopment projects can be significantly higher than similar greenfield projects. Actions by community-based organizations and the public sector that lower the perceived risks of urban redevelopment should lower equity return requirements and increase the availability of private financing. Appraisers would then use lower capitalization rates, and the appraised value of redevelopment projects would increase.

Exhibit 2 | (continued)

Summary of Results

- Public subsidies, debt financing from public agencies and CDFIs, equity infusions from CDCs, and federal or state guarantees are used to make risky projects doable. Federal tax-credit programs increase after-tax returns. Local governments have also rented project space or have helped project owners lease space to major tenants to lower risk.
- The gap-financing model has been used to bring commercial lenders to the table by lowering the project's financial risk to them, but in doing so, the public often receives very minimal financial compensation for the debt capital provided. Instead of offering some given amount or percentage of gap financing a priori, private risks and returns should be carefully assessed to provide just enough financial incentive but not more than necessary.
- One approach to increase value recapture for the existing community is to develop small-area plans that identify a series of redevelopment opportunities. The subsidy levels in the early projects may be substantial, but, as the benefits of successful initial projects are realized, increasingly remunerative positions for the community may be secured in later-stage projects.
- Local public policy can mitigate uncertainty. Although considerable political will is required, local governments can set out clear priorities and plans that target certain areas for development or service improvements. Equally important is the need to identify low priority areas. With consistent implementation over time, developers, landowners, investors and lenders will understand in which areas and roughly when public investments will occur. This information should make expectations more consistent and reduce valuation differences in all areas. As a result, private investment may be more likely in the low-priority areas as well as in those areas targeted for redevelopment in the near term.
- Central city jurisdictions can lower market and financial risk in distressed neighborhoods by developing and steadfastly implementing small-area revitalization plans, improving infrastructure selectively, increasing project scale, clustering development around strong neighborhood anchors, using triage when necessary and promoting competition. Local governments and CDCs also can improve the chances of successful revitalization by organizing and involving neighborhood stakeholders early in the process.
- Local government can reduce development costs through land banking of strategic sites identified in the small-area planning process. These properties will not be subjected to speculative pressures when subsequently slated for redevelopment.
- The public and private participants in urban redevelopment projects should fully discuss project objectives, site plan and design, community involvement, government approvals, construction options, leasing strategies, financing sources and related topics. The participants should discuss openly their perceptions of market and financial risk and the related return requirements. All parties should benefit from a more transparent process. More private capital should flow to better-designed urban redevelopment projects.

The Federal Reserve Bank of Richmond has published a research report on this work. See Malizia and Accordino, 2001.

Conclusion

This qualitative research has generated useful information for project participants, and the findings should be used to inform current public-private redevelopment efforts. Examining central cities that implement some of the strategies recommended above could lend support to them, suggest ways to fine-tune them, or indicate their limitations, especially in overcoming the constraints of weak inner-city markets.

The valuation challenges associated with urban redevelopment projects are a special case of the general challenge of valuing relatively unique and risky projects. Research on how to assess market and financial risk for brownfield projects, urban infill projects, mixed-use projects and other projects advancing the principles of smart growth should generate relevant results for valuing urban redevelopment projects.

Finally, future research should focus on ways to attract more debt and equity capital to urban redevelopment projects, especially from private equity sources that have opted to remain uninvolved to date.

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