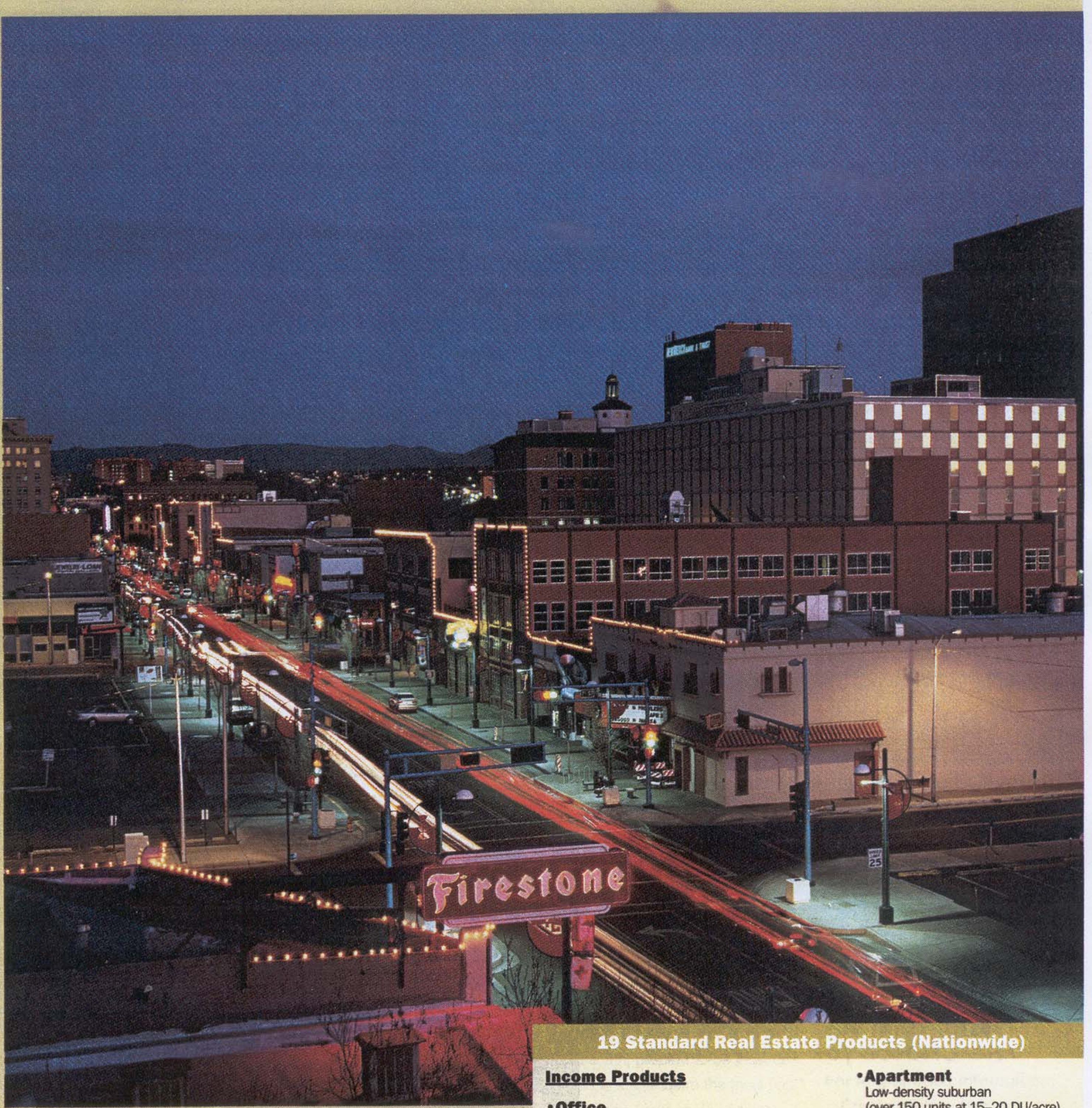


Recovering the Route 66 glitz of Central Avenue in Albuquerque (above) didn't fit today's rigid spec "product" categories (right). Fixing Albuquerque meant lengthening investment cycles that drive low up-front investment (opposite).

19 Standard Real Estate Products (Nationwide)

Income Products

- **Office**
  - Build-to-suit
  - Speculative suburban low-rise
- **Industrial**
  - Build-to-suit
  - Speculative warehouse (28-foot clear span)
  - Research and Development/Flex
- **Retail**
  - Neighborhood (between 80–120,000 square feet)
  - Power (between 120–400,000 square feet)
  - Urban entertainment
- **Hotel**
  - Limited service
  - Full-service business
- **Apartment**
  - Low-density suburban (over 150 units at 15–20 DU/acre)
  - High-density suburban (over 200 units at over 20 DU/acre stick-built construction)
- **Miscellaneous**
  - Self-storage
  - Assisted living

For Sale Products

- **Residential**
  - Entry-level attached
  - Entry-level detached
  - Move-up attached
  - Move-up detached
  - Executive detached

Leading the Money

A new method for financing real estate could place architectural quality center stage. Can the hidebound real estate industry change?

By James S. Russell, AIA

For decades architects have been told they need to learn where the bottom line is and to adapt their aesthetic quests to the tastes of buyers and renters. But as they've done so, few have earned greater trust from their developer clients. Few are asked to innovate, to try new forms of expression, or to plan in a less sprawl-inducing manner.

In most kinds of business there are commodity suppliers and people who seek an edge by delivering something special, new, innovative, intriguing. But real estate development today doesn't work that way. Uniqueness, innovation, and long-term durability have pretty much been driven out of the real estate calculation. Since these are the very qualities architects bring to the table, they find themselves marginalized in the construction segment that, at least in square-footage terms, builds most of America.

It wasn't always so, according to Christopher Leinberger. "We marvel at the architectural design and quality of construction seen in the great retail emporiums, apartments buildings, and office blocks built before World War II," he says. "We think of those builders as possessing immensely greater wealth than we have. In reality, the country's per capita gross domestic product is three times higher today in real terms than in, say, the 1920s."

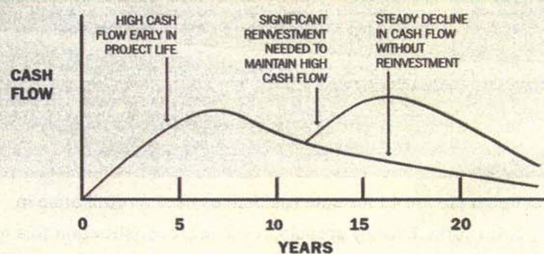
Leinberger is convinced that innovation and higher quality belong in the real estate development process and that they can be valued—but not under the real estate–finance assumptions that apply today. The real difference between the prewar era and now, he contends, is that investors then expected to reap their rewards over a very long time—and did.

He offers a unique perspective. From 1981 until he sold his stake in the real estate consulting firm Robert Charles Lessor three years ago, Leinberger frequently advised clients to get out of declining downtowns and into shiny-windowed office parks on the outer beltways. ("The market was saying move out, and I was often quoted on that," he confirms.) He was one of the first to identify the suburban edge-city trend.

And yet he could not ignore the price premium commanded by such pioneering New Urbanist developments as Seaside, in Florida, which Robert Davis begat 21 years ago. Seaside, declares Leinberger, "turned the Redneck Riviera into the Hamptons of the Southeast." He also approves of Prairie Crossing, an hour's drive northwest of Chicago, where homes in the farmland-preserving development sell at a 40 percent premium.

Moved by such examples, Leinberger decided to get deeper into development himself. Now he is a partner in Albuquerque-based Arcadia Land Company, which he founded in 1997 with Seaside's Davis and James Duckworth of Philadelphia.

Conventional Development Investment Cycle



Real estate as commodity

Leinberger discovered, as previous New Urbanist developers have, that lenders don't like high densities, even when they are pedestrian-friendly. They couldn't value the mix of housing-unit types. And they couldn't reconcile the mixing of retail and residential uses that is key to these projects' character and their aspiration to reduce traffic and parking.

Determined to find out why what seemed to make good sense for communities seemed to make no sense to lenders, he set about categorizing the kinds of projects that could qualify for conventional financing. He found that they fell into only 19 highly simplistic, rigidly prescribed real estate "products" (see chart, opposite). Only such formulaic development could obtain competitive financing terms.

For lenders, requiring developers to build familiar product types is both a reaction to the overbuilding of the 1980s and a sign of the increasing influence of Wall Street on real estate finance

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UNDERWRITING ALBUQUERQUE'S REVIVAL

Leinberger has sliced up the financing of the six-block infill project in Albuquerque both to create early momentum and to operate with more equity up-front. The Historic District Improvement Company (HDIC), a joint venture 75 percent owned by Leinberger's Arcadia Land Company, brought in conventional real estate investors, who will realize quick returns in the first time tranche, from four to six years. HDIC will share second tranche revenues (years six to 12) with its "patient money" investor, the McCune Charitable Foundation, which funds social services and arts programs throughout New Mexico. The foundation's long-term goals permit it to receive revenues later, as long as they are greater than short term gains. The nature of the investment is also consistent with its mission.

The city of Albuquerque is a third tranche investor, putting in dollars up front, primarily by underwriting the construction of a parking structure. Rather than a subsidy or land write-down, the city reaps the benefits in the future: Between years six and 12, it gets 25 percent of the HDIC development's profits; between years 13 and 20, it gets 50 percent, plus all the growth in tax revenues.

To date, HDIC has rehabilitated the American Warehouse into a 40,000-square-foot nightclub combined with an artist loft space. "Urban entertainment and one-of-a-kind attractions build interest in downtown," explains Leinberger. "We put on festivals to get people to come down and take a look."

That's why the Century Theatre Block, an 110,000-square-foot, 14-screen movie theater came next. It's windowless mass was placed in the center of the block, wrapped with restaurants and retail and office space. Under conventional financing, Leinberger explains, it would have been a $10 million project, and he would have had to put in $2.5 million in equity. "To get the quality we need, we had to spend $14 million," he explains. "With patient money involved, we did not have to ask the banks for more money; we raised it as equity." With a higher building budget, the design of the 300-foot-long block fronts could be broken up to reflect the typical scale of historic downtown development. "We were able to change materials and window types along the blockfront," explains Bill Dennis, the architect with the local office of Moule & Polyzoides. "In conventional development, all the materials and all the windows would have been the same." One of Leinberger's early partners actually bowed out because it could not countenance the $80-per-square-foot building costs. Their cinder-block-box norm was $35. Now complete, the theater block is 93 percent leased at rents far higher than average for the area, says Leinberger.

The $5 million first phase of Crossroads, a 55,000-square-foot restaurant, retail, and office rehabilitation project, is complete, with the second, $6 million phase to break ground by the end of the year. A loft-residence building with ground-floor retail and a 176-unit rental apartment building are about to begin construction. Four more largely residential projects are in the pipeline.

The scale of the development has spurred the opening of nine new restaurants and additional new residential development. Without the financing scheme, "I don't think we would see redevelopment at all," says Dennis. "This downtown was clinically dead. I don't think it is yet over the hump, but it's close." *J.S.R.*

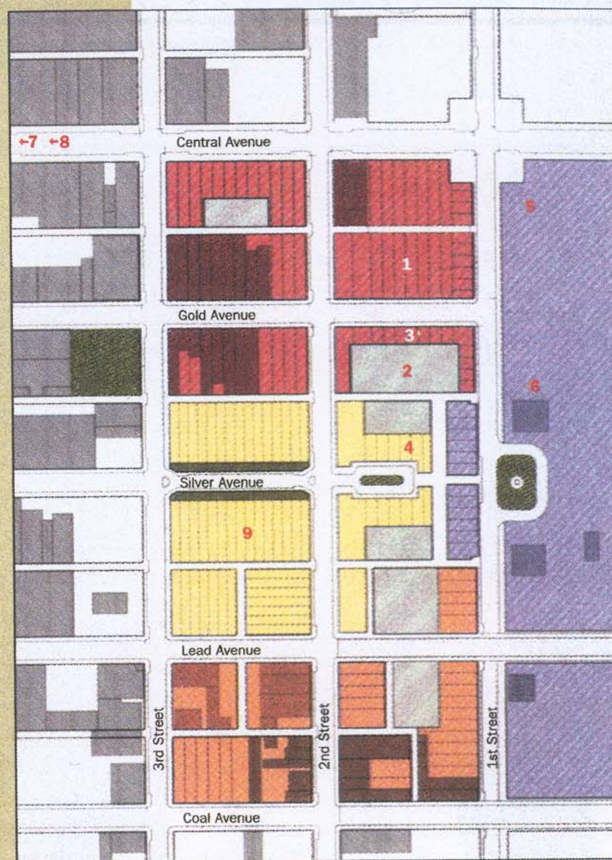
This retail and office building, by Moule & Polyzoides, gives prominence to an important corner and wraps a cinema's blank walls.

that began in the early 1990s. It's safer to underwrite well-understood, generic real estate "products" because, says Leinberger, "they've become graded and commodified—just like pork bellies." This systemic rigidity cannot value almost any kind of architectural grace or planning innovation. That is the reason that stores are made of cinder blocks plopped on vast acreages of asphalt, and condo developments must rely on a few tack-on domestic gestures for "curb appeal." And it is why real estate development differs in no important way anywhere in the country.

If you wonder why bank branches look like discount drugstores instead of the massive stone fortresses of yore, Leinberger can explain that, too. From a tax perspective, commercial real estate has long been treated as a 40-year asset class, which reflected the presumed useful life of the building. But that long-term focus has been undercut by an accounting methodology called discounted cash flow (DCF). DCF analysis, which came to be the standard means for evaluating real estate investments about 40 years ago, tends to show the highest internal rate of return in the first five years of a project's life. With this approach, it naturally follows that the primary way to ensure high short-term returns is

The Design Group architects placed 41 for-sale residences over a retail base in Albuquerque's Gold Avenue Lofts. Entirely presold, it will start construction this month.

1. *Century Theatre Block (completed)*
2. *Parking structure (completed)*
3. *Gold Avenue Lofts*
4. *Silver Court (in design)*
5. *Alvarado Transportation Center (completed)*
6. *Alvarado Transportation Center (phase 2)*
7. *American Warehouse (completed)*
8. *Crossroads Block (completed)*
9. *Apartments and retail (construction imminent)*



HIDC is creating a critical mass of development by concentrating on a six-block area (regulatory plan by Moule & Polyzoides).

to reduce both hard and soft construction costs—decisions that typically translate into lower building quality.

DCF makes it particularly hard to justify mixed-use to lenders because the cash flows tend to peak much later than those for conventional developments (and require high capital investments every 15 years or so to keep performing; see chart, page 98). It is under DCF assumptions that buildings combining high amenity with low energy consumption multiply in Europe but don't pencil-out in the U.S.

The combination of lender-driven building-type rigidity and DCF-driven low-quality construction gives rise to the dispiriting growth that communities increasingly abhor. "All but two of the 19 conforming products create sprawl," says Leinberger.

A place for patient money

Leinberger has made Albuquerque a laboratory for a new finance methodology that could fundamentally change the real estate development process—and the architect's role in it. The city's downtown looks like many others in the American West: as if someone rolled asphalt over a couple of square miles, then dotted it with buildings here and there. Stroll its many pedestrian-free streets and behold an encyclopedia of failed urban-revitalization fads, like the empty pedestrian mall, the atrium skyscrapers riddled with vacant space, the underbooked convention center.

This scene has changed recently (see "Underwriting Albuquerque's Revival," page 100). Around Central Avenue (the old Route 66), $26 million of new commercial construction is in place. It is seeding new residential and mixed-use projects. In a downtown that had no new commercial construction in 15 years, Leinberger says a total of $120 million in work is built, about to begin construction, or in the pipeline.

The new methodology will reward those who build for the long term with innovation and quality as their cornerstones. Leinberger calls it "time tranching," a technique he borrowed from the Resolution Trust Corporation, the agency that found viable owners for all those early-1990s see-through towers left over from 1980s overbuilding. "Risk tranches emerged at that time as a way to grade assets so they could expeditiously be gotten off the books of banks and other lenders," he explains. Projects were sliced up according to risk, with the riskiest elements put first in line for repayment. And it worked.

CONVENTIONAL REAL ESTATE ASSUMPTIONS DRIVE QUALITY DOWN IN A QUEST FOR QUICK RETURNS.

With time tranches, says Leinberger, investors can participate in the income stream at various periods in a project's life, depending on their cash-flow needs. Not all investors need to get their money out in the five to seven years measured by DCF accounting. Pension funds, institutions, publicly held real estate investment trusts (REITs), and foundations often can benefit from investments that pay back over a much longer time horizon—the sixth to the 12th year, for example, or the period beyond the 12th year. "We believe those who take the mid- or long-term piece will find dividends that vastly exceed their expectations," says Leinberger.

In this way, time tranching can make low-cost capital available for projects that have higher than average initial construction costs. Although the architectural design (by Moule & Polyzoides) is in an aesthetically safe, arguably too-ubiquitous neotraditional mode, conventional lenders would have looked askance at the fact that it is infill development and entails a complex mix of uses. The Historic District Improvement Company (controlled primarily by Leinberger's Arcadia Land Company) needed to get parking structures built and a sense of momentum going, which involved high up-front investment.

Time tranching is not likely a panacea for the rictus that afflicts conventional real estate development, but it offers broader lessons for architects. They can make their vision for the future come true if they are willing to pair architectural invention with financial and regulatory innovation. In this way, you don't "follow the money," you lead it.

The Century Theatre block was HDIC's first major investment. With its auditoriums wrapped by retail and offices, it seeded redevelopment in Albuquerque by drawing people downtown who had rarely visited

Working the system

Leinberger was impressed by how patient money worked at Seaside. Davis intentionally developed slowly. Nor did he rush to cash out as Seaside's success grew. "By going slowly, I was able to capture the value we had created." With one-bedroom cottages now commanding million-dollar price tags, Davis's patience has clearly paid off.

Jonathan Rose, a developer of planned infill communities, is not a time-tranche convert, but he sees a larger role for architects willing to understand the real estate finance system and work creatively with it. "One way architects can be useful is by understanding the difference between a securitized mortgage and a Fannie Mae mortgage so that you can do solutions that are easier to finance." (Fannie Mae is a private agency, backed by the government, that purchases bundles of commercial mortgages.)

With even locally originated loans now being sold off through Wall Street, "a kid out of business school who thinks he knows credit risk" is analyzing your loan proposal, he says, and is, in effect, "setting the benchmark for development in America." This dumbed-down lending system means that projects must navigate obsolete standards for parking, and ratios of construction cost to land cost that make sense in exurban greenfield sites but not in infill, urban-revitalization ones.

If short-term economic uncertainty does not stretch into long-run recession, development trends suggest a higher interest in diversity and creativity. One of the reasons Leinberger has confidence in Albuquerque's long-term success is that downtown revitalization has become a well-established and widespread trend. "The countertrend to sprawl is that over the past 10 years a huge market for walkable communities has developed. So 60 percent of downtowns are coming back. And in a few years the rest will come back. Even downtown Detroit has 2 new projects in the market," he says. Recent research at Georgi Tech appears to support Leinberger. In the traffic-snarled Atlant area, 37 percent of people surveyed would prefer to live in walkable community, even though places to walk are all but nor existent in new developments. This sentiment explains wh prices in close-in older neighborhoods are increasing muc more rapidly than prices regionwide. "Clearly there's a mark failure," says Lawrence Frank, the principle investigator.

FINANCIAL AND REGULATORY INNOVATION CAN MAKE BETTER ARCHITECTURE POSSIBLE.

Downtown's renewed appeal also has to do with th aspirations of what economic-development professor Richar Florida calls "the creative class," sought after by employers an urban developers alike. They seek diversity, nightlife, and a authentic sense of place. Younger generations see the presence gays, Florida argues in his book *The Rise of the Creative Cla* (Basic Books), as a proxy for the diversity, openness, an creativity they seek where they live and work, even if they a not themselves gay. Savvy city developers likewise monit housing decisions made by young artists, architects, and stu dents. Their propensity to fix up downtrodden neighborhoo offers a reliable harbinger of renewal.

While an ample supply of landmark-quality o buildings offers good bones for urban revival, insightful deve opers have created value with new architecture. In Seaside cash-poor early days, Davis still found money to erect elabora follies to bridge the ocean dunes. They are the community iconic landmarks, and Davis is mystified why developers don understand their value: "They paid off by creating a strong sen of place." He kept adding these and similar idiosyncratic gra notes even after the community's success was assured.

There are other developers who are in it for more th the money. Like many architects, they see inventive develo ment as strengthening communities and improving t environment. To be a socially committed architect is n enough, however. "Too many well-meaning people cannot ev balance their own checkbooks," says Leinberger. If you ca focus on finance, he stresses, "you'll get blown away." ■