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Taming Gentrification: Using Rising Values to Finance Affordable Housing Through "Value Latching"

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For most of the post-war period, it appeared Americans who had a choice decided to abandon our center cities, packing up for the greener pastures, literally and figuratively, of the suburbs. Only the downtowns of Boston, New York, Chicago and San Francisco seemed to have any vibrancy before 1990. The few poor souls in the country who wanted an urban existence by choice had to be satisfied by these four cities.

The vast majority of America's downtowns, and the areas immediately adjoining them, were seemingly given up by most of us. In 1965, the cover story of *Look* magazine was "Our Sick Cities and How They Can Be Cured". The two places the magazine featured as having taken steps to "cure" themselves were downtown Detroit and Hartford; hardly sterling examples from the perspective of 1990 when the first examples of sustainable downtown revitalization were beginning but generally unnoticed.

The flight to the suburbs was lead by housing starting in the 1950s, then followed by retail in the 1960s and 1970s and finally, by the late 1970s and 1980s, the vast majority of new or re-locating employment. By 1990, only the most diehard downtown loyalists could believe that the slide toward obsolescence was reversible. Yet something unexpected happened…the market began a fundamental change favoring urbanity due to underlying demographic shifts while at the same time the downside of suburban living became obvious to all. Those demographic changes included the relative decline of the "Ozzie and Harriet" family (husband and wife with school age children) to fewer than 25% of all households and Baby Boomers becoming empty nesters that allowed for choices unaffected by the city public school systems. In addition, many suburban-raised Gen Xers concluded that the suburbs were not the only option. If one were to look at the entire array of the most popular Gen X television shows, such as *Dharma and Greg*, *Friends*, *Seinfeld*, *Ally McBeal*, among others, you would conclude that city living was their *only* choice. And the downside of the supposed suburban utopia, including traffic congestion, long commutes and the sterility of the "could be anywhere" placelessness, became continuous local headline news. The suburban dream gone awry was blamed for new social ills such as road rage, obesity and traffic accidents, making the suburbs more dangerous than inner city ghettos for teenagers with high school shootings, due to little sense of place, among others.

As a result of these changes in demand and the growing disillusionment with suburbia, many of our downtowns and the immediate neighborhoods around them experienced a surprising renaissance starting around 1990. The first signs were seen in Baltimore, Chattanooga, San Diego, Seattle, Portland and Denver in the early 1990s. By the end of the decade, the

[1] The author would like to thank the following for their comments and input to this article: Ed Rosenthal and Bart Harvey of The Enterprise Foundation, Pat Bryan, my partner in the Historic District Improvement Company in Albuquerque, Joe Duckworth and Robert Davis, my partners in Arcadia Land Company and David Rusk, author, scholar, former Mayor of Albuquerque and author of a recent study by The Brookings Institution on inclusionary housing.

downtowns of Dallas, Ft. Worth, Austin, Houston, Atlanta, Kansas City, Boise, Salt Lake City, Philadelphia, Nashville and many other cities began to experience a resurgence of new construction and rehabilitation for retail, residential and employment uses. After the stunning success of Camden Yards, the downtown baseball stadium for the Baltimore Orioles, in the early 1990s, 90% of all new professional sports venues were placed downtown during the following decade. The spectacular boom in museum attendance and new construction during the past decade has been almost entirely focused on downtowns. And the wealth, growth and prestige of urban universities, such as the University of Pennsylvania in Philadelphia, New York University and Columbia in Manhattan, multiple schools in downtown Chicago, just to cite a few examples, has helped reinvigorate their downtown neighborhoods.

Today, 50% of American downtowns are on their way to being financially viable and sustainable, meaning that the rents and/or sales prices achieved by the private real estate market would justify replacement development values or higher. By the end of this decade, it is probable that most of the remaining downtowns will move down the path toward financial viability and sustainability. If *Look* magazine was still published, it could even see signs of a turnaround in downtown Detroit…though probably not Hartford since the regional economy is in a long-term tailspin. By achieving financial sustainability, downtown properties will be improved and maintained without subsidy and new construction can be justified in the years to come in most, if not all, American downtowns.

How to Revitalize a Downtown

The method by which a downtown can be revitalized is now reasonably well-understood. Most pre-revitalized downtowns of 1990 only had 9-5 weekday jobs in government, professional services and financial institutions and these employment sectors had been in relative decline or they had joined the move to the suburban business districts. The housing and industrial in and near downtown had generally fallen into decline while the retail had long since headed for the suburban malls.

However, there are almost always old institutions in or near downtown, such as hospitals, universities and museums, which do not have an easy option to re-locate. There may be a local festival or parade that focused downtown. But the most important thing has proven to be the memory, held by those now in power locally, of the grandeur of the 1950s downtown when they were children, and the emotional investment by people of all ages in the metropolitan area's downtown. Using these "levers", a successful revitalization strategy can be built.

Generally speaking, festivals lead the way toward revitalization. These are inexpensive affairs that can be developed or brought back to life quickly to bring suburbanites downtown who have not been there in decades, if ever. The next step is generally urban entertainment, which includes the museums, new stadiums, movie theaters, live theaters, restaurants and specialty shopping. Arranged in a pedestrian, urbane manner, the downtown entertainment district has a distinct and unique market advantage over suburban strip centers and isolated retail buildings surrounded by asphalt parking lots. With a "there there", housing is the next logical step in the revitalization process. In the early 1990s, the new housing was initially rental product since most ownership households would not want to risk their largest asset on a market that did not have a proven re-sale potential. Today, both rental and for-sale product can lead a revitalization effort, especially for-sale housing for Baby Boomers since they would generally not be interested in rental product. The experience of downtown and near downtown housing prices during the late 1990s throughout most of the country has shown them increasing significantly faster than the rest of the metropolitan area. The now proven re-sale market in many downtowns has allowed for for-sale housing to be constructed almost from the beginning of the revitalization effort since these examples are now known outside of the revitalizing downtown. And since the bulk of the housing is either new or rehabilitated, if it is not subsidized, the construction costs force it to be middle or upper-middle income product.

Finally, with the return of the middle and upper-middle class, employment begins to return to the downtown after a half-century of decline. The reason for this is that the very people who occupy the new for-sale housing are usually the decision-makers regarding the location of employment. If the decision-maker lives downtown, why drive to the suburbs every day when he or she could walk to work? Downtown Seattle and Denver are both examples of downtowns with an acceleration in the growth of employment in the downtown following the boom of middle and upper-middle income housing developments during the 1990s.

Recent consumer research in four metropolitan areas by Robert Charles Lesser & Co, the largest independent real estate consulting firm in the country, shows that about a third of metropolitan households desire a pedestrian-oriented, urban lifestyle. Some market experts, such as Todd Zimmerman of Zimmerman-Volk, feel that after a downtown revitalization and other pedestrian-oriented places are in place, it is possible that half of all households will select urban living. The price increases of downtown and near-in housing has been about two to three times higher than the average increase in most metropolitan areas over the past five to six years. All of this is a demonstration of significant pent-up demand.

However, there are not that many providers of urban real estate product; this kind of product is often not allowed by local zoning and neighborhood groups may be opposed to it. The real estate industry is magnificently organized to construct, develop, finance and market suburban stuff. The banks, insurance companies, Wall Street and pension funds that finance the industry usually do not understand urban product. The local zoning codes make mixed-use, high-density urban product illegal, which increases the time, cost and risk of urban development to get variances. And then there is the infamous NIMBY syndrome.

Strong, growing pent-up demand along with limited, constrained supply is the reason downtown and near-in housing prices have been rising so quickly recently. Added to this pressure is the fact that real estate in a financially viable downtown has always been the most expensive in its metropolitan area on a price per square foot basis, due to increased construction and land costs in a dense, multistory configuration compared to the low density suburbs. Compounding this, once a “there there” is created in a formerly decrepit downtown, the market reacts with an intensity that drives prices even higher in a seemingly unstoppable upward spiral…more excitement increases values which creates more investment to create more excitement and on and on. The obvious example is the recent revitalization of Times Square from hooker hang-out to an urban Disneyland for the entire household within a decade. But there are many other examples in the list above that are equally compelling.

There is certainly reason to be optimistic and elated about the surprising turnaround of so many American downtowns. It may even be an underlying factor in slowing or even stopping sprawl as growth is turned around and re-directed inward (see my article “The Beginning of the End of Sprawl” in *Urban Land* magazine, January, 2000). However, like all things in life, this is a double-edged sword. One household’s rising housing values is another household’s ticket to move. Few people of modest means could ever afford to live in the exciting parts of Manhattan but the same situation now exists in Lodo in Denver, the Gas Lamp district of downtown San Diego and countless other revitalized downtowns. And this trend is just barely beginning…consider the affordable housing crisis that will become headlines over the next decade as revitalization picks up even more momentum.

The same situation applies to many small, unusual stores and for urban pioneer households that help make a downtown and its surrounding neighborhoods interesting and filled with character. Students, artists and gay households are probably the best-known urban pioneers. However, many may have to move once the value spiral begins as shown in The *New Yorker* cartoon below. Downtown Pasadena had many funky bars, affordable artists’ lofts and used bookstores in the mid-1980s that were replaced by a new multi-screen movie theater, Borders Books and an urban-sized Saks Fifth Avenue during the 1990s. In general, downtown Pasadena is a far better place today than 15 years ago but there were many positive things lost to revitalization.

So we know how to turn around our downtowns from the experience of the past decade or so. And we know that the very success of the turnaround has unintended consequences on modest income households, those who are schoolteachers, policemen/women, service workers, among others, and small retailers and artists. It is usually public policy that encourages the revitalization of a downtown and the near-in neighborhoods and there is generally public investment to help make it happen. But if the main beneficiaries are the well-to-do, we need to augment that policy so that the revitalized downtown is for all citizens. After all, one of the major benefits of a revitalized downtown is the chance to bring every citizen face-to-face with one another in a safe setting to build a sense of real community. It is a chance to counter the notion given us by the local five o'clock evening news that anyone different than us is dangerous and should be avoided. Yet if by revitalizing our downtowns, we price it out of reach for the service workers, artists and most citizens, the effort is only partially successful.

Who Pays for Downtown Revitalization

It has been learned during the 1990s revitalization efforts that for a downtown turnaround to be successful, the private sector must invest the bulk of the new dollars. In the case of Chattanooga, studies show that for every $1 of public money, there was $12 of private money invested in their highly regarded and emulated revitalization effort during the 1990s. However, the majority of the public investment in Chattanooga and elsewhere came up front, during the early years of the redevelopment process. These are by far the most risky and, therefore, most "expensive" dollars. Without the public investment in land assemblage, infrastructure improvement, cultural and sports investments and operating subsidies for the organizations, public and civic, responsible for the revitalization efforts, those efforts probably would not have happened. These public dollars are contributed by the citizens of the municipality so there is potential leverage that the city could exert, if there is the vision and political will to do so.

As shown in an article I wrote for this journal in May of 2001, entitled "Financing Progressive Development" (www.brookings.edu/es/urban/capitalxchange.htm), downtown redevelopment seems to perform financially differently than conventional suburban development. It would be useful to read that article for a full understanding but, in summary, conventional suburban development has a built-in short-term financial pay-back time horizon. Forced on the real estate industry by the financial underwriting standards of banks and Wall Street, real estate investments must yield returns immediately and generally must be in and out of the project within five to seven years. This short-term bias has forced the real estate development industry to rely upon a standardized list of, by my count, 19 product types that are the same no matter where they are built within the country…and most of the industrialized and industrializing world is now following suit. This is why the country's suburban built environment looks the same whether one is in the San Fernando Valley or the 128 corridor of Boston, except for the superficial regional architectural details that are bolted onto the standard cinder block building. This short-term bias has also forced real estate developers to construct buildings that have an equally short-term life by slashing construction costs. Since the underwriting methodology used by virtually all financial institutions only reward short-term financial returns, giving almost no "net present value" for financial returns beyond year seven, our built environment is now a reflection of this short-term methodology.

Yet real estate is a long-term asset class and it has been such for 5,000 years. Building for the "ages" has been a motivation for real estate developers for centuries. It is the reason pre-World War II retail emporiums, office buildings and apartment buildings are proudly referred to as "pre-war" when they are sold or leased. It is the reason the IRS allows real estate to be depreciated over 37 years, not seven, much to the investment community's chagrin. Most well-built buildings have a natural life of about 40 years, at which point the then owner has an option of renovating, tearing down and rebuilding, or letting it sink into a slum. If market rents allow for one of the first two options, it is almost always cheaper in the short-term to tear down and rebuild to meet contemporary space and infrastructure requirements. However, if the building has won a place in the owner's heart and taxpayers' emotions so that it qualifies for Federal historic tax credits, many

times the building can be renovated in an economical manner. This is a great benefit to our society and to the character of our cities, particularly the downtowns where many of these grand structures are located.

It is hard to imagine the standardized suburban real estate products built today or over the past two generations being around long enough or, more significantly, being emotionally important enough to be renovated. Many of the inexpensive, short-term building materials used today guarantee built-in obsolescence after a few years. In addition, the throwaway nature of conventional sprawl development most times mean market demand has moved further out to the fringe of the metropolitan area, leaving the strip center or walk-up apartment complex to become a slum. The financial performance of the asset usually follows the curve labeled “a” on the Exhibit I below. If suburban sprawl and market demand have not moved on to greener pastures, there can be a complete reinvestment in the project, roughly between years seven and ten, as shown in curve “b” on the exhibit. The then owner will rebuild in a similar inexpensive but, for the time-being, new manner. In essence, the throwaway nature of sprawl means that investors, who are looking for fast returns, are only willing to bet on a neighborhood for seven to ten years. If sprawl, which is to a large measure caused by this investment time horizon, has not destroyed the neighborhood, then they are willing to invest for an additional seven to ten years. Thus we have created and perpetuated throwaway metropolitan areas. Contrast this with the great sections of cities here and abroad that have been built for the ages and, as a result, are much loved, protected and provide pride for their residents…not to mention act as a draw for visitors.

However, traditional real estate investment (pre-war) and what I call “progressive” development (New Urbanism, downtown revitalization, conservation development, Smart Growth, etc.) appears to have a different investment return curve, though I will caution the reader that this has not been definitely proven. As shown on curve “c” of Exhibit I, downtown revitalization does not financially perform as well as conventional development in the early years, but accelerates during the mid- to long-term. The reason for this is that in the early years of, say, a downtown revitalization effort, the critical mass of a pedestrian-oriented place is generally not there. Only attractive to the smaller market of urban pioneers, the early project or projects do not cash flow as well as they hopefully will in the future once a critical mass of things to do in the downtown emerges. However, if new developments are built within walking distance within subsequent years, the original projects will benefit from the growing critical mass, and cash flow should improve without further investment on the part of the initial projects’ owners. Given the current lack of pedestrian-oriented places in most metropolitan areas, the pent-up demand for urbanity will start the upward spiral of activity, investment returns and value enhancement.

The newer fringe projects built in the downtown will go through the same mid-term improvement in activity and cash flow generation as more land is swept into the core of the revitalization effort. As the core of activity spreads, land values in the area adjacent to the core will begin to move upward, as there is market anticipation that the future values will be higher than can be justified by the current uses. A new project may locate a block or so from the edge of what the market defines to be an acceptable, safe location but due to its very development, that definition could expand to include the new project.

All of this private investment is beneficial for the city’s tax base and for risk-tolerant private investors. The city gets a downtown where folks can people-watch for free while enjoying the buzz of a vibrant place unlike any of the suburban, car-oriented competition. Downtown returns to its rightful place as *the* community-gathering place. It can become a unique place in the metropolitan area and that uniqueness continues the upward value spiral. However, the downside of this upturn in activity and values is that prices and rents rise, most times to levels never anticipated when the revitalization effort began. And the experience of downtowns like Denver and Seattle suggest that they rise faster than anyone would have guessed. They become the highest sale prices and rents on a per square foot basis in the metropolitan area, many times within a decade or so of the initial revitalization effort. As a result, many of the people who initially pioneered the revitalization or those who work in the downtown at lower paying jobs are priced

out of the restaurants, commercial space and housing. As Manhattan, the Gold Coast of Chicago and the Back Bay of Boston showed over the past 50 years as the rest of the country sprawled, the most expensive real estate is *urban* real estate in a vibrant downtown. This experience is now being replicated in and near downtowns throughout the country.

The issue of escalating values has generally been described as "gentrification", which to social justice activists is a pejorative term. The church leaders in Harlem, north of the Upper West Side of Manhattan, have been trying for the past decade to stem the tide of gentrification in their formerly desperately poor African-American and Hispanic neighborhood. Ironically, many of those moving into Harlem are black professionals, the result of the significant growth of the black middle class over the past 20 years, but nonetheless displacing poorer members of the community. Northwest of downtown Chicago, the Lincoln Park neighborhood has completely gentrified over the past generation, improving at an amazing pace. The close-in 1920s executive neighborhood of Ansley Park north of downtown Atlanta has seen housing values increase literally 60 to 100-fold in the past 20 years. The housing sections to the east of downtown, built during the early 20th century as middle income housing, are now experiencing the same value appreciation over the past five years. The same has happened in the near-in urban neighborhoods of Boise, Phoenix, Austin and countless other cities throughout the country.

Since this about-face has occurred so quickly and the goal of downtown revitalization appeared so doubtful a decade ago, few people have been concerned that revitalization could be *too* successful, creating an affordable housing and commercial space problem. Being concerned about these issues when a downtown was in its post-war dire condition would have been considered laughable…a nice problem to have. Well, we now have it.

As mentioned above, we know how to revitalize our downtowns and there appears to be pent-up demand for more to occur. The amount of pent-up market demand may even lead to the growing urbanization of suburban business districts. So it is now time to face the issue of affordability. The alternative is to consider a future of small versions of the Upper East Side of Manhattan throughout the country. That is, fabulously wealthy swaths of the city where anyone making less than $200,000 cannot dream of living, even if they are employed in the many stores, restaurants and offices in the neighborhood. And yet much of this was made possible by the initial high-risk public investment in revitalization.

<u>Current Options for Maintaining Affordable Rents and Sales Prices</u>

There have been three basic options for maintaining affordability, particularly housing affordability: rent control regulation, subsidy and inclusionary zoning. Rent control has been a method of regulating housing for centuries and was imposed in many American cities during the Second World War. Housing subsidies became part of Federal and local policy, starting in the 1930s, to deal with the growing "urban crisis", continuing to this day primarily in the form of the Federal low income housing tax credit program, vouchers, Section 8 and the Hope VI program. Inclusionary zoning was first introduced in the 1970s to help integrate the suburbs. I will briefly discuss each below regarding their efficacy.

The regulation of housing rents was implemented in many cities during the Second World War to avoid "price gouging" during a national emergency. With little in the way of new construction during the war and the tremendous movement of people around the country, a housing shortage quickly developed. This shortage was not relieved until the 1950s. While most cities removed rent controls during the 1950s and 1960s, New York, San Francisco and Boston have kept them in place, modified many times in many ways, until the present day. Studied in great depth, there is reasonable consensus among urban observers that rent controls have been a disaster for the built environment due to deferred maintenance and increased uncertainty and costs to lobby the political process to obtain rent increases. It has also turned out to be mainly a subsidy for the middle class, not the lower or working classes that needed it the most. This is because the middle class tends to know how to work the system better. Finally, it has perversely reduced

options for those “lucky” enough to maintain below market rents. Those who obtain a rent-controlled apartment are hesitant to leave it for fear of losing the subsidy, reducing their desire to get on with their lives as changes occur. Few serious observers of the affordable housing situation would recommend rent controls as a solution. It only is maintained in New York City, Boston and San Francisco due to the political clout of the beneficiaries of the system.

Interestingly, rent regulation in its many ever-changing forms have been used primarily in New York City, Boston and San Francisco over the past 60 years, three of the four downtowns that maintained viability during the post-war period. The very urban viability and vibrancy caused local urban housing prices to be among the highest in the country, providing political support for a continuation of this failed policy. The fourth vital post-war downtown, Chicago, has always been too much of a “free market” town to go in for such manipulations of the housing market.

The subsidization of affordable housing has produced some of the greatest social science failures and some of what looks like the greatest successful experiments of the past three generations. The failures are epitomized by the Pruit-Igoye housing project in St. Louis, torn down after 30 brutal years of existence. It gave subsidized housing projects a terrible name. Concentrating the poor in high-density housing showed that social pathologies multiple and the downward spiral of poverty becomes almost impossible to overcome. On the other hand, the low income tax credit for multi-housing rental housing, particularly the enlightened Hope VI program, is replacing conventional concentrated affordable housing projects with mixed-income developments. The program includes mixing subsidized housing of between 20% and 60% with market rate housing and so far has been shown to be successful. However, these projects have a time limit on the developer/owner for how long the affordable units have to be affordable.

However, there are two major drawbacks of subsidized affordable housing. The first is that there is not enough Federal government funding to meet the need. The second is that the current level of funding is always liable to be cut. All subsidies and grants for affordable housing will, at some point during the political process, face cuts or elimination.

Inclusionary zoning has been used as a generally positive tool, most impressively in Montgomery County, Maryland. This enlightened county mandated that 15% of new housing in projects over 50 units be affordable (Moderately Priced Dwelling Units in the local government jargon). By providing for the need of thousands of middle and lower-middle income households, the county has added to its ability to economically grow and probably decreased traffic congestion from what it would have been without the policy, though it is hard for Montgomery County commuters to believe this. All of this without massive governmental subsidies since developers were given a 22% “bonus density” to allow them to build more units than allowed by zoning. The reason inclusionary zoning works is that the new market rate housing partially subsidies the affordable product, the other part of the subsidy being provided by the “free” land over the 22% more housing allowed to be built. Since it is applied throughout Montgomery County, which is a large high-priced housing market with substantial underlying economic growth, it “leveled the playing field” throughout a large market which could absorb the partial subsidy without much observable affect. In all probability, an inclusionary policy throughout an entire metropolitan area would be the most effective method of providing affordable housing. However, the Montgomery Counties of this world are few and far between. Getting suburban counties to enact such enlightened policies will probably not take hold anytime soon.

Mandating inclusionary housing policies in a revitalizing downtown would also present another problem. Ten to twenty years after revitalization has begun the new market rate housing being built may be able to absorb the subsidy imposed on market rate housing to pay for the subsidy for affordable housing. However, initially in the revitalization process, this requirement would kill most housing projects. An inclusionary zoning requirement would mean an urban pioneering housing developer first has to pay more than he can afford for land to build the project, since he generally has to compete with surface parking, valued at $10 to $15 per square foot, than the project can support. Second, the developer is building in a part of town that has little in the way

of a track record (thus increasing the cost of financing) *and*, third, would have to subsidize a certain percentage of the units built by charging more for the market rate units. During the early years of a revitalization process, this is probably far too great of a financial burden for even a high-risk tolerant, socially enlightened developer to be able to shoulder.

As mentioned above, inclusionary zoning would not be a problem if the entire metropolitan area housing market imposed it uniformly. However, the chances of that happening in our lifetimes are rather slim, though progressive leaders, such as David Rusk, continue to do research and raise this as one of the best ways to increase affordable housing. So if inclusionary zoning, the best hope for providing affordable housing, does not work in the early years of a downtown revitalization process, what are the options for addressing this issue, particularly before it becomes a problem that will be very expensive to solve?

The Concept of "Value-Latching"

The concept of value-latching is that as the downtown values rise, both rents and sales prices, there could be negotiated a system of dedicated cash flow sources for affordable housing and affordable commercial rents. As the downtown succeeds in its revitalization, there would automatically be more funding for affordable housing/commercial rents over time. The organization responsible for developing/supporting the affordable rents would have a built-in incentive for the downtown revitalization to succeed. Systematically latching onto the rising property values and rents would provide a permanent source of funding for affordable housing/commercial rents, not dependent on annual government appropriations, which are never adequate and are liable to be cut.

A special purpose, non-profit organization would need to be created for the value-latching scheme. This organization would be the repository for the cash flows generated by the various downtown projects that would participate in the program. That non-profit would also determine the criteria by which the funds would be spent. Undoubtedly this would be one of the best non-profit boards to serve on since there would be a minimum of fund-raising involved. The bulk of the board work would be determining how to spend, not how to raise, the funds.

There are a number of ways to latch onto rising property values. The most direct would be to provide ownership for the non-profit in various real estate projects that were helped by the City in the revitalization process. Direct ownership and participation in the cash flows similar to any other limited partner in projects, assuming there is no obligation for equity infusions into the projects if the need arrived, is the most direct, though difficult to achieve.

A second method is to receive any promised cash flows that may be coming back to the City if the private real estate projects had the provision of a pay-back to the City for up-front assistance. For instance, if the City provided land, parking, infrastructure or tax abatement assistance to a private project and the City is due to receive future cash flow participation in return, that cash flow participation could be assigned to the non-profit.

A third method is to have an agreement with any private developer that the City helps which allows the non-profit to participate in cash flows from the projects above the projects' proforma financial returns. These proforma financial returns are those submitted to the construction lender prior to construction beginning. Once projections are exceeded, indicating that the project is successful and the lenders and equity investors are satisfied with the promised returns, a portion of the marginal cash flow above this level, say 20%, could be provided to the non-profit. For example, if the proforma cash flow of a project is $250,000 for the second year of operations, but the actual cash flow was $300,000, the non-profit would receive $10,000 ($50,000 X 20%).

A variation on this third method looks to the individual retail leases, which tend to have "percentage rent" clauses when sales volumes for the retailer are higher than the "natural break point". The natural break point is the level of sales volume at which the percentage of the fixed

monthly rent is at, say, 5% of sales. Once sales reach the natural break point, every sales dollar for the retailer above those results in additional rent being paid to the landlord of, say, five cents. Value latching may have a negotiated provision that a portion of the percentage rent could be paid to the non-profit. For example, if the natural break point per month is $20,000 in sales and the rent is $1000 (5% of total sales volume), if the sales reached $22,500, there would be an additional rent due of $112.50 ($2250 X 5% percentage rent). There could be a provision that once percentage rents are achieved, meaning that the retailer is doing rather well, part of the percentage rent, say 1%, would go to the non-profit from the landlord. In the example above, that would result in $22.50 for the non-profit ($2250 X 1%). Since this may be the lowest amount from any source discussed so far, perhaps a match by the retailer, say an additional 1%, could be negotiated.

Why would a private developer or a retailer agree to participate in such a scheme to fund the non-profit? The simple answer is that it could be a prerequisite if they want to be involved with the City-sponsored revitalization effort. Secondarily, such an approach has considerable positive, public perception benefits. However, it is very important that cash flow participation should only take place after the project achieves success, not a “tax” on the project regardless of how well it is doing. In essence, the City will tell the developers that they are being asked to participate *only* if they are financially successful so that they are only contributing after the developers and their investors have made the amount of return that they have expected to make. Negotiating with a private developer for cash flow participation over and above what they expect to make is not that difficult an argument to make. The developers are giving away something they do not have in hand at the beginning of the project and only have to provide after they are successful.

Why would the City be interested in such an arrangement? The first reason is that it is a form of privatization of a City responsibility in an area that the non-profit sector has proven themselves as capable, possibly even more capable, than the public sector in addressing. The success of non-profits like Habitat for Humanity, The Enterprise Foundation, community development corporations, among many others, demonstrates that the non-profit sector knows how to address the issue of affordability. If the City has negotiated to participate in the developers’ cash flows due to its up-front investments in the developer’s project, the use of the resulting cash flows for affordable housing/commercial rents by a non-profit organization is a “win/win” scenario for the public sector.

An added benefit of establishing a non-profit focused on affordability is having a stable organization that can also search and apply for other governmental and foundation funding to assist in their mission. Many funding sources are not readily apparent and it takes time, experience and effort to obtain grants and low-interest loans. This non-profit, with a reliable source of funding to survive day-to-day, would have the luxury of continually scanning the environment for additional funding. Also, many of the affordable space programs are only available to non-profits.

There is also a unique opportunity for raising initial capital for the non-profit if these cash flow sources mentioned above are made available to it. The problem of affordable housing/commercial rents becomes more difficult to address as the downtown revitalization progresses and values increase. The cash flow sources outlined above become available to the non-profit starting three to five years into the revitalization effort and they will not really be significant until after year five. However, if the non-profit is set up at the same time as the revitalization effort starts, which is best since the negotiations with the initial developers must take place at that point, and there was start-up funding available, the issue of affordability could be addressed *immediately*. It is far less expensive in the early years of revitalization to buy land and buildings, tie up market-rate housing units for lease to qualifying moderate-income tenants, or any other strategy to insure there is an adequate inventory of affordable space in the downtown. But how would the non-profit raise initial capital?

One method is to adapt “tax-increment financing” (TIF) from the public finance profession. With TIF, the city borrows money that will be paid back from the tax revenues (property, sales or other) that would be generated from the investment of those borrowed funds in a private sector development. If there are borrowed TIF funds available for, say, land acquisition, which is then contributed to a private development which produces local tax revenue after it is built, those new taxes from the project are pledged to repay the borrowed funds. A “non-profit TIF” could raise the initial capital for the affordable housing and commercial space non-profit organization, addressing the affordability in a revitalizing downtown early in the process. By pledging the future cash flow sources that the non-profit has developed, as outlined above or others not yet understood, for repayment, the non-profit could “kick start” its affordability programs in the critical early years of the revitalization process when it is easier to do. These borrowed funds would have to come from a foundation source at the present time, borrowing “program-related investment” (PRI) funds, since it is unlikely a conventional public finance vehicle, similar to a conventional TIF loan, would be available. Perhaps with a successful track record from various cities, public finance loan funds may be possible in the future for “non-profit TIFs”.

Use of Funds to Create Affordability

How the funds, whether initial borrowed capital or ongoing cash flow from revitalizing downtown projects, are spent is the prerogative of the non-profit board. Ideally, the board should be comprised of representatives of the downtown civic and business community, the developers who are providing the funding through their projects, the city, downtown community associations and providers of affordable housing.

The first key issue the board will face is which part of the city should be targeted for the efforts of the non-profit. There will be a tendency for existing community development corporations and neighborhood groups *outside* of the downtown to want a piece of the pie. These neighborhood groups are organized and probably feel that downtown revitalization is getting too many resources as it is, even if the downtown in the early stages of revitalization looks like a ghost town after 5 PM and on weekends. It is crucial to understand that the non-profit’s mission is for the people who are not yet living and working in the downtown, people who do not have a voice. The affordability efforts should first focus on the downtown core and possibly the couple blocks on the border of adjacent neighborhoods that meld into downtown. If the funds are siphoned off to organized neighborhoods outside downtown, the very resources necessary to achieve a balanced income neighborhood downtown will not be available. After the downtown is well on its way back, the board may be able to consider investing in the neighborhoods bordering the downtown core, when housing values there will begin to rise as a result of the downtown comeback.

A second key issue for the board will be the affordable retention policy of affordable space, either housing or commercial. There will always be a temptation to convert affordable space to market rate for financial reasons to provide additional funding for future affordable projects. This will be a difficult policy since it is a fine line between providing the proper amount of affordable space with the responsibility of maintaining organizational financial sustainability and meeting financial responsibilities, such as paying back loans.

The strategic program options for the non-profit range from direct to indirect. Some of the options include the following:

1. Direct Subsidies—For households or small businesses, the most direct program is to provide subsidies to bridge the gap between the market rent for living units or commercial space and a pre-defined rent that moderate-income households and businesses could pay. For housing units, income criteria must be determined, possibly following Federal guidelines, though this is not necessary since this is a private program. The board of the non-profit may also determine that the recipient must work downtown within walking distance, thus avoiding the need for at least one of the cars in the household. The average cost of owning and operating a car, according to the AAA, is $7,000 per year, after tax, a sizable portion of a household

budget for a qualifying household. For small businesses and the civic non-profit downtown space users, the most significant board decision is which of them will qualify. There will be significant disagreement over who gets assistance and who does not. Assuming that decision has been made, there will be negotiations with the landlord and the small business/civic non-profit tenant as to the amount of the subsidy. There is a need to determine how much the small business/civic non-profit can actually pay, based upon operating history. There is also the possibility of negotiating with the landlord to obtain a below market rent. The gap between what the small business/civic non-profit can pay and what the landlord will charge is the subsidy. There will be a need to review the subsidies on a periodic basis to ensure ongoing qualification and the board may want to have a time limit. The obvious downside of this program is that it is pure subsidy with no financial return and as the market rents increase, assuming that it increases faster than wages which is likely, the amount of subsidy will have to increase. While the cash flow to the non-profit will also increase due to the rising values throughout downtown, this program does not enhance the financial sustainability of the non-profit.

2. Investment in Real Estate Projects—A more active, though indirect, method of ensuring affordability is by providing investment (equity or low interest debt) for the development, redevelopment or acquisition of residential and commercial projects undertaken by the private sector. This can only be done if there is initial capital raised as a result of the non-profit TIF approach outlined above since it requires current funding. The investment of equity capital in a private sector project, possibly in a project that is part of the non-profit's cash flow sharing scheme, can guarantee that a certain percentage of the units or the commercial space will be affordable according to the non-profit's definition. This will provide affordability for the life of the project without further subsidy. In addition, there may be the ability to obtain additional ownership in the project by the non-profit, depending on the deal structure, thus providing further financial sustainability for the non-profit. The amount of subsidy for making a portion of a project affordable is capped and there may even be upside financial return potential. The same management of the process of determining who is qualified, whether household or small business/civic non-profit, as discussed in #1 above would apply.
3. Participation in Development by Land/Building Acquisition—The acquisition of land and/or buildings by the non-profit is a method by which the non-profit can build an inventory for redevelopment/development that will have an affordable component. This is particularly productive in the early years of the revitalization effort when acquisitions will be the cheapest. The non-profit could contribute the land and/or building to a private developer in exchange for a certain amount of affordable space, and possible participation in the project's cash flow. The non-profit may also engage in development on its own account, if it has the capacity. Finally, the non-profit may contribute the land and/or building to a community development corporation or, say, a non-profit arts organization, to develop an affordable project. Once again, the same management of the process of determining who is qualified, whether household or small business/civic non-profit, as discussed in #1 above would apply.

Undoubtedly there are other methods for the non-profit to create and maintain affordable residential and commercial space. Only through the implementation of such a system could the possibilities be fleshed out.

However, in concept the combination of a TIF-like up-front funding with either investment in real estate projects (#2 above) or participation in development by land/building acquisition (#3) could lead to a particularly powerful two-prong approach with multiple cash flow sources for the non-profit. One of the concerns about borrowing up-front funds is that the repayment of those funds, which would have to start in years three to five, would divert much of the pledged cash flow which would just be starting at that point. The non-profit would not be that much in the way of new investment or subsidy dollars while the original loan was being paid back. However, as shown in Exhibit II, there can be a second cash flow source created by careful investment of the original loan amount in appreciating ownership stakes in others' projects or projects owned outright by the non-profit. Of course, the non-profit cannot forget that it is has a mission to provide affordable space so it cannot bring every square foot of owned or partially owned real estate up to market

rent, since it would defeat its very reason for existence. But the *market rate* space that it owns will probably increase relatively significantly over the first three to five years, as will the cash flow associated with the projects. This second cash flow source could be the day-to-day source for new subsidies, new investments and new projects, as well as overhead coverage.

Downtown Albuquerque as a Potential Model

The revitalization of downtown Albuquerque may provide a model of value-latching. The for-profit Historic District Improvement Company (HDIC) is developing a 12-block redevelopment area at the gateway into downtown. The total development value of the district is projected to be $120 to $130 million with a $22 million movie theater, specialty retail, restaurants, office and parking deck completed as of December of 2001. Additional projects include for-sale and rental housing, additional specialty retail and restaurants and a grocery store. HDIC is comprised of Arcadia Land Company, one of the largest New Urbanist development firms in the country, and the McCune Charitable Foundation, the largest foundation in the state, as an equity investor.

The development agreement with the City calls for the City to invest land, parking structures, infrastructure improvements and tax abatement valued at $14 million. In exchange, HDIC has committed 25% of its cash flow to the City during years six through twelve and 50% for years thirteen through twenty. This arrangement is projected to yield a return of $18 million back to the City over twenty years, in addition to a projected $29 million in *net* increased tax revenues.

HDIC and the McCune Charitable Foundation hired the Enterprise Foundation, one of the nation's largest facilitators and financiers of affordable housing, to determine the need for affordable residential and commercial space in the revitalizing downtown, underway at the time of the writing of this article. In addition, Enterprise is setting up the new affordable residential and commercial non-profit. The board includes the head of one of the largest and most successful community development corporations, the managing partner of HDIC, a representative of the city, the local head of Fannie Mae, among others.

The new non-profit will have cash flow sources relating to HDIC projects that potentially will include the following:

- a small percentage ownership in HDIC and its projected cash flows,
- 20% of the marginal cash flow above the projected financial returns that were provided to the construction lender for any HDIC development project,
- The pledge of a portion, and possibly all, of the City's share of cash flow from HDIC projects during year six through twenty.

These possible cash flow sources are being made available due to HDIC's commitment to mixed-income housing and arts space during the revitalization of the downtown. When the Development Agreement with HDIC was originally negotiated, the City had committed that its share of the HDIC cash flow would be re-invested in the downtown. What convinced the City to consider pledging some or all of their share of the HDIC cash flows to the non-profit was the possibility of immediate, up-front funding of the non-profit and its work.

Enterprise and HDIC began shopping various national foundations for their interest in providing a major program-related investment to the to-be-formed non-profit. Given the projections of the HDIC projects' financial performance and the lower-than-market interest rate charged for a PRI loan, the amount that could be raised was between $8 and $10 million. The primary source of repayment is the pledged cash flows from the HDIC projects while there is a possibility that the investment of these funds could yield additional financial returns over and above providing affordable residential and commercial space.

Obviously the Albuquerque model is not yet complete and will need to be updated. Yet it shows that the City, affordable housing and commercial advocates, and a private developer can all share a common goal of revitalization, rising property values *and* affordability. Each interest

group has slightly different reasons for agreeing to contribute their resources and time to achieving a goal of a mixed-income downtown revival. In addition to a commitment to that goal, the City sees immediate investment from a third party, i.e. an outside foundation, which is fresh cash into the community. The developer sees a more diverse and lively downtown, reinforcing his market-rate efforts. The affordable housing and commercial advocates sees a meaningful commitment to the goal of affordable space downtown, effective means by which to address the goal and the ability to get a head start towards its realization.

And importantly, all interested parties are agreeing that revitalization is good for all. There is no trade-off between revitalization and affordability. Equally importantly, the new downtown that is rising will be a place for all citizens of the community, the overriding goal of the effort in the first place.

Conclusions

Value-latching can become a reality with a cooperative City that is undergoing a revitalization process and willing developers, or developers that the City can “encourage” to be willing. It is a classic example of “making lemonade from lemons.” A revitalizing downtown is a positive situation for our society, but has a “sour” unintended consequence of either driving modest income households and businesses from their home or place of business or not allowing persons of modest means to move to the revitalized downtown. This now recurring situation throughout the country can potentially be “sweetened” by having a value-latching scheme pay for the efforts of a non-profit to provide scattered site affordable housing and commercial space in the downtown.

The value-latching concept negotiates participation by a non-profit in future cash flows from real estate projects in a revitalizing downtown. There is participation only if the projects are successful in the mid- to long-term so that there is no short-term drag on their initial efforts when market conditions are most difficult and lenders’ and investors’ needs are most insistent. By pledging these cash flows as the source of repayment, a foundation program-related investment loan can potentially be arranged, providing an up-front source of investment capital. Investing that up-front capital in appreciating, affordable projects, the non-profit can, not only create permanently affordable space, but possibly a second cash flow source for the non-profit beyond year three of its existence.

Value-latching can be added to the arsenal of existing affordable housing tools, discussed above. Like many things in life, the solution to affordable housing will come from a combination of many solutions. However, value-latching can broaden its focus to affordable commercial space and other socially desirable goals, such as parks and open space.

The beauty of value-latching transcends the obvious financial benefits. It means that many of the players involved with bringing the downtown back, the City, developers, investors, neighborhood representatives, affordable housing advocates and arts groups, can all share the same economic incentives for the revitalization effort to succeed. There will also be much more diversity in the revitalized downtown, diversity of residents and commercial users. Personally, I would find downtown Pasadena much more interesting and real today, if some of the old musty used bookstores were still around rather than just Borders, as nice of an establishment as it is. Ultimately, the key to the success of a downtown throughout history has been complexity and diversity. Value-latching is a means to maintain and increase the complexity and diversity of a revitalizing downtown in a financially sustainable manner.

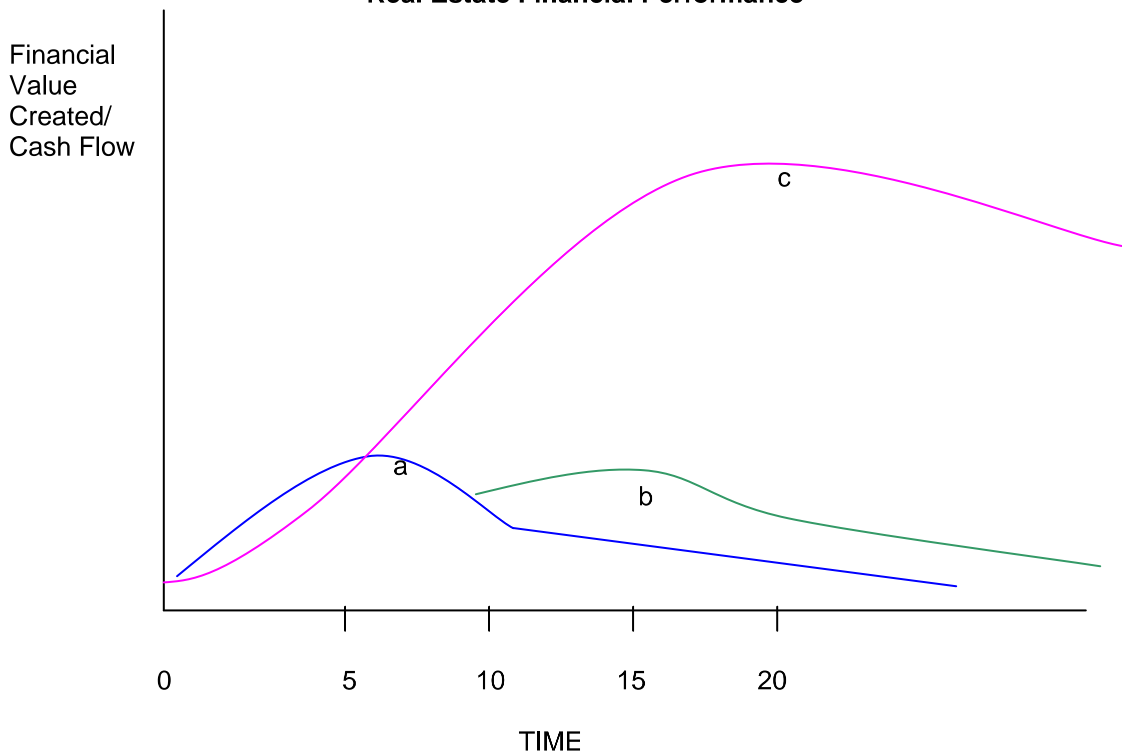
EXHIBIT I – Conventional versus Progressive
Real Estate Financial Performance
Financial
Value
Created/
Cash Flow
a
b
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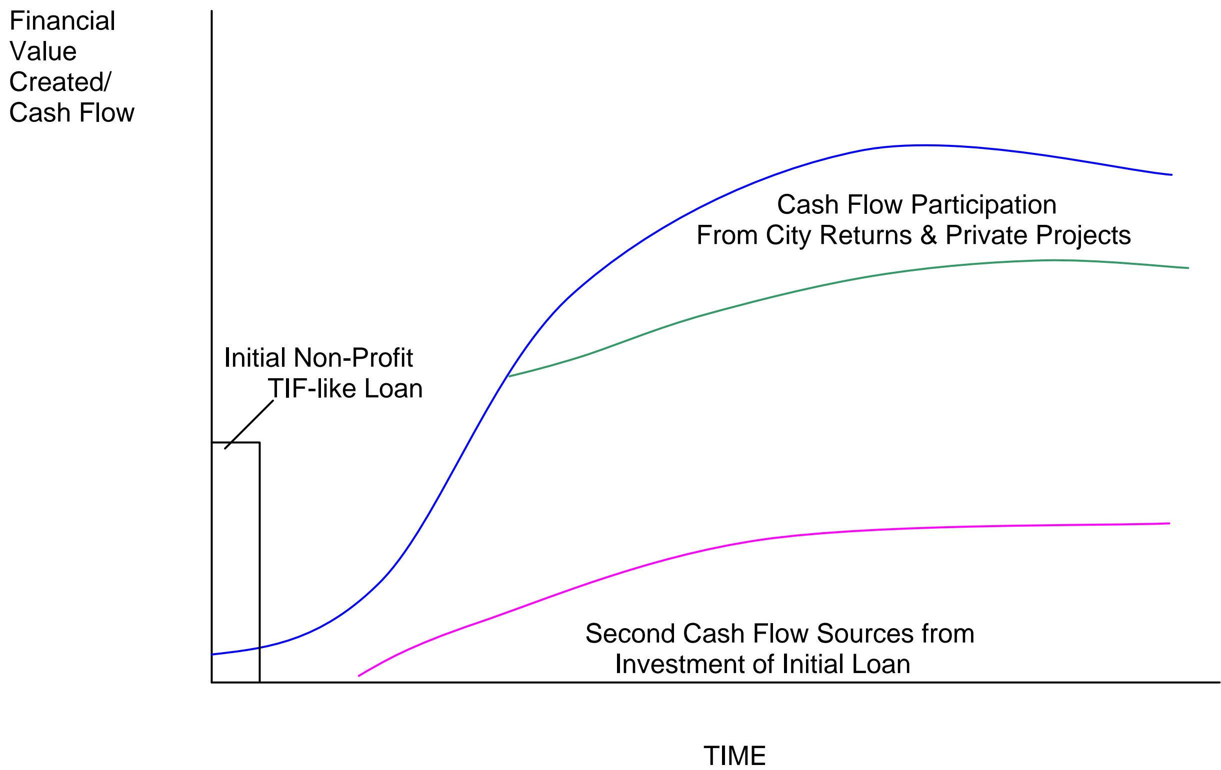
5
10
15
20
TIME

EXHIBIT II – Cash Flow Sources for the Affordable Non-Profit Organization with an Initial Loan to Capitalize its Activities



"It was an artist's loft. Now it's a lawyer's loft."