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How Mixed-Use Developers Can Avoid Tripping Up

By John Egan

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Mixed-use has been hailed as the greatest idea in commercial real estate since the debut of the enclosed mall. But increasingly, this mega-hyped product type has become more difficult to execute. High construction costs, stepped-up competition, financial hurdles and the slumping condo market are among the obstacles.

“There are too many retail projects chasing rooftops, so along with the slowdown in housing, some of these mixed-use projects may struggle,” says Jeffrey Spector, an analyst at UBS Securities LLC who tracks companies pursuing mixed-use. “Not all of these announced mixed-use projects are going to stick.”

Some developments have struggled or been scuttled completely. In November, the San Francisco Bay Area suburb of Fremont, Calif. and developer James Tong Inc. dropped joint plans for a 58,000 sq. ft. retail and condo development. Project construction estimates were at least $20 million higher than the company budgeted. Rising costs, along with a softening condo market, led to abandonment of the deal, according to Elisa Tierney, director of Fremont's redevelopment agency.

Michael Beyard, an urban planner, economist and senior resident fellow at the Urban Land Institute, attributes mixed-use collapses to economic changes, intense competition, inability to secure financing and failure to attract anchor tenants.

Roll of the dice

A more brass-tacks view is that mixed-use is simply an extraordinarily complicated product type to pull off. “I think a lot of people are likely to trip up in doing mixed-use because the risks are greater and because there are more opportunities to make mistakes,” says Lee Wagman, CEO of Santa Monica, Calif.-based developer The Martin Group of Cos. Inc.

“You not only have to get one project right, you have to get two or three projects right. The rule of thumb is that all of the pieces have to stand alone and work individually.”

That wasn't the case with the proposed $1.5 billion Urban Village in Las Vegas. Unveiled in April 2005, the 50-acre mixed-use development on the South Strip was touted by developer Diversified Real Estate Group LLC as “a new Manhattan in Las Vegas.”

But before the first shovel pierced the ground, the Las Vegas developer sold the project the following year to Centex Destination Properties and North Dakota hotel developer Tharaldson Cos. Confronted by weak condo sales and high construction costs, Diversified decided to cash out and concentrate on other Las Vegas projects. But the company still had a link to the project, since Gary Tharaldson, head of the hotel development company, is also chairman of Diversified.

Nearly a year later, Centex and Tharaldson broke ground on the first phase of the six-building project, which was to have included 2,400 condo units, along with shops and restaurants.

Then — déjà vu — less than four months passed and developers halted construction again, refunded deposits to about 75 condo buyers and put the property up for sale. In the end, Centex Corp. opted to redirect capital from Urban Village into its core home building business in order to generate higher returns, says spokesman Ken Smalling.

The reasons? Slower-than-expected condo sales, higher-than-anticipated contract cancellation rates and a soaring number of condos flooding the Las Vegas market. Indeed, sales of condos and townhomes fell 47% this March compared with last March, according to the Las Vegas Association of Realtors, and the March 2006 number was down 12% from the previous year.

Sharing the risk

If executed properly, mixed-use projects spread the development risk. For instance, if the residential component falters, a developer can shift the mix toward another use, such as retail, Beyard says. Furthermore, rental rates and sale prices in mixed-use projects can be 10% to 20% higher than single-use developments because tenants and buyers consider mixed-use more desirable and will pay a premium to be part of the trend.

To further disperse the risk, experts cite development strategies, joint ventures and municipal partnerships as key to making a mixed-use project a winner.

The development of mixed-use has to be choreographed, since the components are interdependent. If the retail element is built in isolation, for instance, it might not get the desired traffic, says Edgar Jones, vice president of Rockefeller Group Development Corp. Working together helps mixed-use developers wield strength and weather financial downturns.

“To expect the office, residential and retail sectors to be humming at the same time is unreasonable,” says Jones, who oversees Miramar Town Center, a $235 million mixed-use retail, residential and office development rising in Miramar, Fla. Rockefeller, based in New York, elected to pair up with a unit of Los

Angeles-based Kimco Realty Corp. (NYSE: KIM) because of the company's strong financial position, lengthy track record in retail and key relationships with retailers. Jones says Lowell Homes Inc. in Miami was picked as the residential developer because of its strong regional presence.

In a recent industry survey of developers, investors, building managers and other professionals, more than two-thirds (68.4%) defined mixed-use as pedestrian-oriented, and said it maximizes space usage (68.4%) while cutting down on traffic and sprawl (70.1%). The vast majority (93.3%) said mixed-use will grow as a share of overall development in the next five years. More than four of 10 respondents (43%) said they most rely on a mixed-use partner for expertise with condos, followed by apartments (42%). The survey was conducted by the Building Owners and Managers Association International, the International Council of Shopping Centers, the National Association of Industrial and Office Properties, and the National Multi Housing Council. Experts say multifamily experience is in demand because many mixed-use developers already know the office and retail sectors.

Many developers understand only one land-use type, says Beyard. “Retail is the most difficult to add to the mix, and it needs to be the first use considered in planning a mixed-use project, not the last. Most office and residential developers don't know anything about retail.”

Retail's success rests on factors such as merchandising, the blend of stores, consumer behavior and customer access, Beyard says. “The other land uses are primarily about supply and demand as long as certain basic characteristics are met.”

Because UDR Inc. (NYSE: UDR), an apartment REIT based in Richmond, Va., knows little about retail, the firm hires consultants. “We understand [mixed-use], and we're not afraid of it,” says Mark Culwell, senior vice president of development at UDR. “What we are afraid of doing is trying to be retail guys. We're not retail guys — we're apartment guys.”

Municipal incentives matter

Some developers count on municipal aid to make their projects fly. With Rockefeller's Miramar project, the city undertook considerable legwork, says Wazir Ishmael, assistant city manager.

Miramar accelerated the permit process, carried out the zoning and platting work, and spent $1 million to create a book detailing the desired look and feel of the development. The city also performed soil and water tests and market analysis, Ishmael says. Such cooperation can trim costs and bolster developers' returns.

Miramar also provided about $700,000 in financial incentives to be used for police, fire and other services. The city's aid was invaluable, Jones says. “Without some help from the city, we could not have proceeded.” Eventually, Miramar Town Center is expected to generate between $1.3 million and $1.8 million in annual property tax revenue.

Elsewhere, the $4 billion Atlantic Yards mixed-use project undertaken by Forest City Enterprises in Brooklyn has received $200 million in public subsidies.

In Atlanta, Atlantic Station has benefited from the establishment in 1999 of a tax allocation district — akin to a tax increment financing district — to provide money for redevelopment of the former brownfield site, which had been contaminated by heavy industrial use. The district has enabled issuance of more than $300 million in bonds.

Experts say cities welcome mixed-use because it draws young professionals and empty nesters to urban areas, creates a desirable live/work/play setting and boosts density. So communities like Brooklyn and Miramar are eager to grant financial incentives.

Nearly 60% of developers and other real estate professionals engaged in mixed-use say involvement by the public sector is instrumental to the financial success of a project, according to the survey sponsored by four industry groups.

Beyard, the Urban Land Institute expert, says mixed-use projects generally require public-private partnerships if civic, cultural, sports or affordable-housing benefits are expected, or if major infrastructure improvements are needed.

“But probably the most common partnerships involve public financing of parking structures in large mixed-use projects, if the public sector wants an urban development rather than a suburban one with parking lots,” he explains.

In-house expertise

Contrary to many of their mixed-use brethren, Forest City and a handful of other developers undertake these complex projects almost exclusively in-house.

“We're one of the few developers out there who can do that,” says Mark Bulmash, senior vice president of development in the company's commercial group, referring to the company's dozen or so mixed-use projects. That's because Forest City, with annual revenue of $1.2 billion, has a wealth of in-house expertise in residential, office and retail, he says.

Atlantic Station LLC does use joint ventures but has taken a bigger role in the partnerships for its 138-acre mixed-use project in Atlanta. Going forward, Atlantic Station and its owners, AIG Global Real Estate Investment Corp. and Jacoby Development Inc., will keep the land for the project, rather than sell parcels to outside partners, says Brian Leary, vice president of design and development at AIG Global Real Estate. In previous phases of Atlantic Station, the owners had not held all of the land.

The 15 million sq. ft., $2 billion Atlantic Station contains office, retail, hotel and residential components. Beazer Homes USA Inc., Lane Co. and Novare Group Inc. are Atlantic Station's residential and hotel partners. Beazer is scheduled to finish the residential portion of the project this year, Leary says, while the roles of Lane and Novare are expected to continue indefinitely.

From here on, Atlantic Station will develop the acreage by itself or with partners. “We've learned that the outright sale of land to a third-party entity may not fully capture the value of an Atlantic Station address going forward,” Leary says.

Developer Regent Partners LLC, based in Atlanta, went beyond a joint venture to strengthen its mixed-use bench. Last year, Regent decided it needed to shore up residential expertise to complement the firm's office and lodging know-how.

Rather than build a residential team internally, Regent merged with Urban Realty Partners LLC, an Atlanta-based specialist in residential real estate. The acquirer absorbed six Urban Realty employees who helped shape Regent's new residential development division. The firm has at least eight mixed-use projects in the planning stages, most valued at more than $1 billion. Reid Freeman, president of Regent, expects equity return rates of 11% to 15%.

“We are in the development business for the long haul,” Freeman says. “We are willing to time the market, to wait to develop. We are about long-term success, not short-term profit.”

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